

**Money, Money,
Money, Ain't It
Funny . . .**

Sheryl Sutherland

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Why do some people have money and not others?

SHOAL BAY

Money, Money, Money, Ain't It Funny... How to Wire your Brain for Wealth

Sheryl Sutherland

Author of Girls Just Want To Have Fund\$

‘Only the powerless live in a money culture and know nothing about money.’

Why do some people have money and not others? Is it through inheritance, or earning megabucks for some esoteric talent? Or being parsimonious and darning your own socks? Do some people have an innate ability, or is it a matter of attitude and calculation?

For many, the enigma of money is surrounded by mystery and dysfunction. Money is an emotional currency that relates to our need for security, respect, love, power and self-determination. It’s therefore important that we understand our own relationship to money – in other words, we need to understand our financial behaviour.

Research shows that to change our financial behaviour we must first learn new skills: skills that focus on motivation, knowledge, understanding, wisdom and discipline. The focus of this book is not how to pick the right shares, or get rich quick – it is about looking at yourself.

Sheryl Sutherland asks the pertinent questions: what inhibits us from taking the right steps to find financial freedom? Why do we respond in some ways and not others? Why do our emotions govern our financial decisions?

Money, Money, Money... will help you handle your finances with a greater sense of ease and awareness.

Money, Money, Money, Ain't It Funny ...

How to Wire your Brain for Wealth

Sheryl Sutherland



SHOAL BAY

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Introduction

Why do some people have money and others not? Is it a matter of inheritance, of earning megabucks for some esoteric talent, or is it from being parsimonious and darning your socks? Do some people have an innate ability, or is it a matter of attitude and calculation? Money's enigma is surrounded by mystery and dysfunction. Money permeates the whole of human existence; our financial maturity is interdependent with our personal maturity.

Thousands of books written have focused on investment and money but have done so from the perspective of the 'best' investment types or 'way to wealth'. As an author I am also guilty of relying on rational thinking to change behaviour. Rational thought however often doesn't work or breaks down under stress when most needed. This book is different in that it focuses on what inhibits us from taking successful financial steps.

You are probably familiar with some of the jokes we pass to one another at the expense of economists, financial commentators or advisors. One of my favourite financial gurus says that all forecasters should wear a pointed hat, carry a wand and a crystal ball. Then we would know how much value to place on their utterances. The wild card that blows their predictions and our financial plans out of the water is our behaviour. The human mind, after centuries of philosophy, psychology and contemplation is still not fully understood.

In my day job as a financial planner I write plans and advise people on how to invest and handle money. I have noticed however, over the last couple of decades that although my suggestions are acknowledged to be valid and sensible at the time, my clients have found acting on those suggestions extremely difficult. Or as one client said to me, accusingly, 'You are talking to me on a rational basis.'

This phenomenon has been the subject of intense study over the last decade as advisers, planners, economists and many others attempt to unravel the financial decision-making process. In writing this book, it is my intention to help people handle their financial lives with a greater level of ease and awareness. This book will give you the following:

- ☐ Ideas which may be familiar but which are seen through a different lens.
- ☐ New techniques for analysing attitudes to money.
- ☐ Guidelines for handling myriad financial relationships.
- ☐ Simple clear assessment techniques.

You will also learn about:

- ☐ The difference between rational thought and emotional action in relation to money.
- ☐ Handling and improving financial relationships.
- ☐ Changing your financial life and the financial lives of those you care about.

This book will not tell you what to buy, when to invest, give you any fantastic trading system, or tell you how to save. There are plenty of other books out there that cover those topics. This book will give you new guidelines for reconstructing your financial life, which will enhance your sense of security and success in life. This book will help you identify and resolve the issues you have surrounding money, investments and the financial transactions you make.

In this book, you will complete quizzes, read case studies and examine checklists. Notice your reactions:

- ☐ What judgements do you make about people?
- ☐ Do you think their behaviours are right or wrong?
- ☐ Has anything like this ever happened to you – if so how did you act?
- ☐ Why do you think these behaviours occurred?

After you have finished each chapter go back and do the quizzes, examine the ‘Do you do this?’ lists. Can you isolate and evaluate your behaviour with a relevant financial transaction? What could you have done differently to improve your outcome?

Hopefully by the end of this book you will have a better understanding of what makes YOU tick in the world of money and investment. You will be able to make decisions based on your strengths, while watching out for your weaknesses. All to make you happier and wealthier money managers.

Sheryl Sutherland
April, 2007

The Rational Investor?

An investment in knowledge
always pays the best interest.

Benjamin Franklin

THE RATIONAL INVESTOR

Psychological factors are paramount in the struggle for financial success, whether you are taking on a mortgage, investing for your retirement or taking on a purchase plan. Self-discipline and self-control are the key ingredients. Discipline is a term with broad implications. As we all know, in order to resolve a problem, we first need to identify that problem. For 99.9 per cent of us the problem is in our minds – our attitude to consumer purchasing, investment activity and borrowing.

What are the psychological forces that underlie success or failure? Can the necessary and appropriate behaviours be learned?

Here are a few things that reading this book can do for you:

- ☐ Your loans will decrease and your profits will increase.
- ☐ Your attitude to your financial life will be less emotional and more rational.
- ☐ You will be more positive about your financial decisions – your self-confidence will increase.
- ☐ You will find a financial structure that best suits your attitude to risk, your temperament and your personality.
- ☐ You will make fewer errors of poor judgement and recognise potential errors early.
- ☐ You will understand more clearly the relationship between the media, fundamental analysis, yourself and the sharemarket.
- ☐ You will be less concerned with the success of others, or the actions of others.
- ☐ You will take a long-term view of your portfolio.

Look around you, can you see a rational purchaser or investor? According to traditional economic theory, we are always rational

when reacting to financial information to maximise profits, or to obtain the best deal. Traditional economic theory does not allow for those of us who invest on a hunch, make an impulse buy, go to the mall for retail therapy, and for those of us who often don't know or care what we want, whether we can afford it, or what we owe. It doesn't allow for those of us who buy through pride or envy, or on a hot tip, or who simply succumb to peer pressure, or the financial fashion of the time; or those who invert financial snobbery by claiming to be a contrarian or to have inside knowledge.

I know you, dear reader, are rational – but who else is? No one you know? That's right, most people don't save enough money; most people have counterproductive financial habits – ultimately most people are broke when they retire. This is very sobering to anyone who is dedicated to helping people help themselves financially. Why does this happen?

Mostly we are an intelligent species. We have the most remarkable cognitive abilities, a unique and rich system of language and communication, a visual system capable of faithfully recording the world around us with extraordinary veracity, in complex detail and in real time. Our abilities in thinking and in problem solving have allowed us to adapt the environment to suit ourselves, and to develop science and technology. So, given these remarkable attributes, why is it we are often irrational when it comes to money?

In the lengthy development of humankind 'money' is a recent development. Learning about money is a skill we have to master, like driving a car or reading. Some of us never grasp the skill of dealing with money (or driving or reading for that matter). Money doesn't make sense to us – nor does the concept of value. If you are dehydrated and descending Mt Everest would you swap the world's most valuable diamond for a bottle of water. Which begs the question: which has the most value? We do not think in mathematical abstractions so we easily ascribe characteristics to money that it does not possess. Money is fungible, that is, it is a commodity which can be exchanged for a vast array of goods and services.

We are not good statisticians either. As a nation of gamblers we are unable to perceive that playing the pokies or betting on horses has no correlation with high risk and high return. Losses add up but the gains don't increase accordingly, but we think they do. We are unable to calculate the odds of winning.

We like odds of 50 per cent more than probabilities of 25 per cent or 75 per cent. The prospect of 100 per cent probability is as exciting to us as zero probability. Easy profits are not as exciting as the pursuit of risky bets.

What are the odds of dying in a plane crash compared to dying on

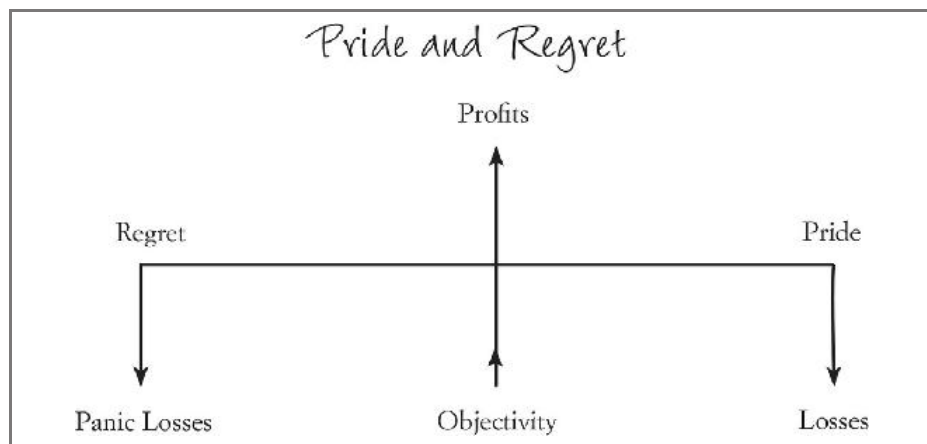
the roads? Twice as many people die on the roads during a year than the total of those who have died in air accidents. Yet we fear flying more than driving. Air fatalities evoke shock but road deaths are simply another standard news item. We are drawn to the most astonishing event regardless of its probability.

OVERCONFIDENCE

When we display overconfidence, we think we know more than we do, we are in control of the results of our investments, and we underestimate risk. (See Chapter Two for more information on Overconfidence, p 18.)

PRIDE AND REGRET

Our investing decisions are often controlled by pride and regret. In all aspects of our life we avoid actions that give rise to regret. In investment selling the losers make us regret buying them in the first place, especially when the loss is no longer a 'paper' loss. We hold on to the losses in the hope they may recover. Seeking pride in our actions (making a profit is of course a great source of pride) we sell the winners so we can congratulate ourselves on making a profit. (See Chapter Three on Pride and Regret, p 31.)



THE PAST

The effect of the financial experiences we have had in the past is enormous. If we have experienced a gain or a profit we are more willing to take a risk; if not we are averse to risk-taking; and, if already committed, go into 'break-even' mode: 'I'll sell those shares as

soon as the value comes back up to the original capital I invested.’ To complicate matters we often reframe our past – if we remember a bad financial experience as being worse than it was we avoid similar experiences, or if better than it was we look for similar experiences. In fact psychologists have found that we tend to reject, ignore or minimise anything that conflicts with our positive self-image. (See Chapter Four on Considering the Past, p 40.)

MENTAL ACCOUNTING

We all handle money differently depending on its source. Consider this, you sell your house and make a profit of \$50,000, what do you do with the proceeds? You win \$50,000 at the casino, what do you do with the money? Most of us treat the gain from a house sale very seriously indeed; however money from the casino can be used frivolously. Think of how we talk about money – dirty money, easy money and free money – the terminology designates the mental accounts in which the money is deposited. (See Chapter Five on Mental Accounting, p 50.)

Meet Chloe. Chloe is the only woman I know who has loving family but only has a photo of herself and Jimmy Choo in her wallet. Chloe bought yet another pair of Jimmy Choo's. They felt perfectly comfortable at the store, but the first day she wore them they hurt. A few days later she tried them on again, but they hurt even more. What happens now? My predictions are:

- 1 The more she paid for the shoes, the more times she will try and wear them (this choice may be rational, especially if they have to be replaced with another expensive pair).
- 2 Eventually she will stop wearing the shoes, *but she won't throw them away*. The more she paid for the shoes, the longer they will sit in the back of her closet. (This behaviour cannot be rational unless expensive shoes take up less space.)
- 3 At some point, she will throw the shoes away, regardless of what they cost, the payment having been fully 'depreciated'. She will be able to rationalise her 'loss' by putting it in a different mental account.

FAMILIARITY

Investing is a complex process, our brains recognise this and take shortcuts to reduce the complexity of analysing information, and this can lead to errors in judgement. We also often confuse a 'good' company with a 'good' investment. Is a company that contributes a portion of its profits to charity a good company, a good investment or both? Frequently we also invest on the basis of *familiarity*. I have heard clients say, 'I heard Joan Bloggs being interviewed so I bought shares in her company.' No analysis of likely return or risk was made

– the investor knew and liked Joan Bloggs, and considered that a sufficient basis on which to make an investment decision.

SOCIAL INTERACTION

A decade ago we rarely talked about money or investments. While we still seldom disclose earnings or our investments in dollar value, we now talk about money, and get plenty of financial advice from friends and family. We also get advice from the media, self-help books, companies promoting their products or from investment clubs. *Social interacting* is now a powerful force in our financial lives. (See Chapter Seven on Social Interaction, p 69.)

Emotion and investment decisions

Emotion and investment decisions do not mix well but are often seen in tandem. Background moods and feelings greatly influence financial decisions. In the past, economists have assumed that because money is involved, reason and logic will overcome emotion and psychological biases, but the reality is different. If emotions did not affect financial markets there would be no sunshine effect, holiday effect or market bubbles (more on this later.)

Real-life money and real-life investing are simple but not easy. Like the rest of the world, New Zealanders are irrational, have poor self-control, and are either unrealistically and boundlessly optimistic, or too passive. The deck is stacked against us, but we can take steps to stack it back in our favour. We can isolate and implement strategies to overcome our habits and biases and to neutralise our hardwiring. Then we can obtain successful financial outcomes.

Overconfidence

'Your overconfidence is your weakness.'

Luke Skywalker,
Return of the Jedi

OVERCONFIDENCE

We all know someone who is overconfident; the arrogant 'know it all' whose every decision, action and skill is exceptional. For example, if you ask other drivers whether their driving ability is average, above average or below average in comparison to the others on the road and they are sure to answer 'above average'. But what about you? how would you rank yourself as a driver in comparison to those you see on the road? above average, wouldn't you say? You have that in common with 82 per cent of sampled college students in a recent survey who rated themselves in the top 30 per cent of their group. However, statistically, the study results should show one-third above average, one-third average, and one-third below average. This shows overconfidence.

So apart from drivers, who else is overconfident? Doctors, psychologists, security analysts and economic forecasters are among the culprits. This suggests that 'experts' tend to be overconfident compared to relatively inexperienced individuals. Overconfidence is more severe for diffuse tasks, such as making diagnoses of illnesses that require judgement, than for mechanical tasks such as resolving arithmetic problems; and tasks for which delayed feedback is received as opposed to tasks that give immediate and conclusive outcomes, such as weather forecasting and horse racing handicapping. Overconfidence is found not only in our assessment of our driving abilities, or analysing the weather but also in our financial decision-making. Investors can view themselves as more capable of making judgements than they actually are, so that they overestimate their ability and underestimate the likelihood of judgemental errors. We tend to view ourselves through rose-tinted glasses and value our views, relative to those of others, more highly. But we also display 'biased self-attribution': our confidence grows when public opinion is

in agreement with our views, but does not fall commensurately when the views of others contradict our opinions. And, of course, we credit ourselves with past successes and blame external factors for failures.

How does overconfidence manifest itself financially? We overestimate our level of knowledge, underestimate risk and exaggerate our ability to control events.

Overconfidence can also be called optimism, an essential force for everyday life. Who wants to constantly be doubting the success of every endeavour they undertake? The trick is to distinguish the difference between what you really know, and what you think you know.

People make changes in their lives and portfolios because they are confident that they are making a change for the better, without confidence they would sit still.

Case Study

A room full of graduates, all presumably of similar intelligence, were asked to rate their investment ability relative to that of others in the room on a scale of 1 – 10. We know the average should be 5, but it was 7.5.

Overconfidence and how it affects investor decisions

Overconfidence is more severe for complex tasks that require a judgement call.

Consider, for example, the investing process. Simply put, you need to gather information, analyse that information and make a decision based on that information. You then implement that decision, monitor and review the results, making portfolio adjustments as you deem necessary. Obviously you need to continue to update yourself on economic and market information during the course of your investing. This can lead to overconfidence in your ability.

Gender overconfidence and performance

Although both sexes exhibit overconfidence, men are generally more overconfident than women. The strongest differences are for topics in 'masculine' domains such as mathematics. Men feel more competent than women do in financial matters – indeed casual observation reveals that men are disproportionately represented in financial services.

Confidence depends on clear feedback, if that is absent or ambiguous women seem to underestimate their abilities relative to that of men. The sharemarket does not provide clear, unambiguous feedback.

If you are an overconfident investor you will buy and sell too

frequently because you are too certain in your opinions; too certain of the accuracy of the information you have obtained; and too certain of your ability to interpret it. It is also likely that any opinions of others that don't coincide with yours, are ignored.

Men are more overconfident than women when investing. Men trade more frequently than women do. What is more, single men trade the most, followed by married men, married women and single women. One researcher studied over 150,000 trading accounts; women sold an average of 53 per cent of the shares they held each year, while men traded a magnificent 77 per cent a year. Men need to watch their innate tendency to be overconfident.

Symptoms of overconfidence:

- ☐ Willingness to take large risks.
- ☐ Overweighting your investments in one area, property for example.
- ☐ Disinclination to follow a plan.
- ☐ Disregard of facts that don't fit with your view.
- ☐ Willingness to hold onto losses.
- ☐ A 'let's take a chance' attitude.
- ☐ A belief that the best is yet to come.

ILLUSION OF KNOWLEDGE AND CONTROL

Clever marketers know that the illusion of knowledge and control over the results of events appeals to the human psyche.

We are willing to spend enormous amounts of money for products and services such as share-trading programmes about which we know very little. We purchase these services because we believe that the more knowledge we have, the more accurate our forecasts. But does more knowledge and more accurate forecasts lead to better quality decisions? If a little knowledge is a dangerous thing, how would you define a lot of knowledge?

Behaviourists have coined a term 'calibrated confidence', which means knowing what you can and can't do. It requires being comfortable with the knowledge of how limited our abilities really are. If this sounds defeatist, bear in mind that lack of confidence in one's ability usually results in a lack of activity and low activity levels have been proven to produce better returns.

Online trading and performance

Constant portfolio turnover is largely an attempt to buy and sell at the right time.

One of the joys of the 21st century is the quick and unparalleled access we have to vast quantities of data, courtesy of Professor Google. The internet is changing how information is delivered to

investors and has increased the ease with which we can act on that information. We can access all manner of esoteric financial data, historical data such as prices, returns, operational performance, as well as real-time news, prices and volume. We can read commentaries, predictions, analyst's recommendations, and the sayings of sages such as Warren Buffett and George Souros.

Figures for internet trading in New Zealand are not readily available but our cousins in Australia claim that nearly 30 per cent of weekly trading flows through internet brokers. In fact there are some concerns that in the near future any unusual surge in trading – the type brought on by an unexpected event – could paralyse market centres.

Case Study

A group of investors who trade online expected their own portfolios to beat the market. They expected a return of 15.7 per cent on their portfolios and the market to return 13.3 per cent. They were overconfident.

The enormous amount of online data enables us to confirm our prior beliefs. The quality of advice varies greatly and investors are often unable to distinguish good advice from bad. Indeed, with so much 'free' advice available, investors can be unwilling to pay for advice from other sources.

Access to all this knowledge gives us the illusion of control. If you make your own choice of investment rather than utilise the advice of a broker or planner, your feeling of control over the outcome will be stronger. An early positive outcome also gives the investor a greater illusion of control – through endorsing the choice made. In my day job as a financial planner, I frequently find that clients prefer property as an investment precisely because of that feeling of control.

If you are an online investor you are probably male, young, with no children, have a higher level of self-reported investment knowledge and prefer to invest in small-cap shares with a higher level of risk. You will have experienced a higher level of profitability before going online. In other words, you are probably a speculative trader; nearly doubling the level of risk you are taking in comparison to those investors who still buy and sell through the more traditional channels. Furthermore, you will experience below par performance. Bear this in mind:

'Trigger happy traders may be prone to shooting themselves in the foot.'

From online trading to gambling

Today, you can pad from your bed to your computer in your furry

slippers and start clicking away your funds at 4 am. Online gambling gives the impression of being high-yield and low-risk. A virtual casino is practically barrier-free, so it seems risk-free. In fact, it is *low*-yield and *high*-risk. Further, it contains even more unknowns (the state of security, unfair practices by the house, collusion among players) than casino gambling. As the advent of the internet makes clear, gambling itself is evolving too quickly for us to catch up.

Ways ignorance about maths and probability can hurt you

There is a scene in a Simpson's episode where a psychologist is giving a 'team talk'. He makes the statement, 'You are all very good players'. The team members mimic the psychologist, 'We are all very good players'. Then the psychologist says, 'You will beat Shelbyville!'. And the team, again in unison, reply, 'We will beat Shelbyville!' By this time the psychologist is raising his voice, and he shouts, 'You will give 120 per cent!' But the team, still in unison, reply, 'But hold on, that's impossible. No one can give more than 100 per cent. By definition that is the most anyone can give.'

Many of us are not as smart as Homer's team and have problems dealing with maths. Maths anxiety is found in people who find arithmetic stressful and panic about mathematical problems. This can affect people who are perfectly competent – and this can affect many investors. Some of the feelings that prohibit us from feeling comfortable dealing with numbers are quite natural responses to uncertainty, to coincidence, or to misconceptions about the nature and importance of maths.

I frequently see investors omitting to consider inflation – thanks to a psychological phenomenon known as the money illusion. This involves a confusion between 'nominal' changes in money, that is greater or lesser numbers of actual dollars and 'real' changes, that is greater or lesser buying power. This can be dangerous because when we are analysing our likely returns we need to grasp the effect inflation has on the investments that we make. For example, if we have a bank investment offering us 7 per cent, we still take out tax at 39 per cent, and inflation at 3 per cent. Our real rate of return is ... *not* 7 per cent.

A recent survey to test our level of financial knowledge found specific areas of weakness in mortgages, compound interest and investments:

- ☐ 25 per cent of people with home loans did not know that increasing the frequency of repayments from monthly to fortnightly reduced the amount of interest they would pay over the life of the loan.
- ☐ Only 30 per cent identified that a range of shares would make more money than fixed interest investments and savings accounts over 18

years.

- ☐ When tested on their understanding of compound interest, only 53 per cent correctly identified that they would earn more interest on a one-year term deposit when the interest was paid back quarterly into the term deposit, rather than paid at the end of the term.
- ☐ 20 per cent thought they could reduce risk by investing only in property.

Those with lower levels of personal financial knowledge were more likely to be young (18 to 24) or older (75+), people with lower levels of formal education, income and net wealth, and renters rather than homeowners.

The survey also revealed some surprising conclusions, including that a small number of the highest earners have a low level of financial smarts:

- ☐ 15 per cent of those with a net wealth of more than \$300,000 had a low level of personal financial knowledge.
- ☐ 18 per cent of those with tertiary or post graduate education had a low level of personal financial knowledge.
- ☐ 46 per cent of those with no formal qualifications had a good or high level of personal financial knowledge.
- ☐ 8 per cent who earned less than \$20,000 were in the high knowledge group.

So which group do you think you would fall into?

Money illusion can play tricks with history too – a sort of 20/20 hindsight. Consider the perennial favourite, property investment. We have had some periods of exceptional growth and anecdotal evidence has homeowners telling us of the enormous gain in value their homes show, they forget that during many growth phases inflation has also been rising like a soufflé.

This illusion causes us to react to nominal changes in price as opposed to the more meaningful percentage change, frequently fostered, I have to say, by the media aided and abetted by the real estate industry.

Compounding: The Eighth Wonder of the World

Imagine you came to work for me. I offer you \$1 million for one month's work payable on day one of the 30 day period, or \$1,000 on the first day, doubling everyday.

The first option sounds great **but** if you took the \$1,000 and doubled it every

day, at the end of two weeks you would have \$8.1 million. At the end of a 30 day month, the figure is in the billions.

A STOCKMARKET SCAM

This is a classic numbers game illustrating how investors can be fooled into believing someone can predict the future.

Imagine this; you get a letter or an email from a firm which tells you how they beat the markets. They may tell you they have a great computer model and are able to predict the markets, you may also read some heartfelt endorsements as to the success of the great system they are using. They predict the market will rise. What you don't know, however, is that they have sent a similar letter to 19,999 people and a letter stating the opposite case to another 20,000 people. Obviously one scenario will be the correct prediction. Those people who received the correct prediction are then split into two groups, half get the letter predicting growth, and half get the letter predicting a decline. The group is divided again and now have three correct predictions. This can be repeated until the recipients of the letter have received enough correct predictions for the scam artist to pounce. Recipients are advised that further information will cost an annual subscription or that they need to buy their trading system.

There is always enough random success to justify anything to someone who wants to believe. If we fare well from this type of experience we are likely to tell everyone about our perspicacity, or, if we don't, we are likely to keep quiet. We have a tendency to filter out the bad and focus on the successful. Casinos know this – they don't display the more likely loss ratio to gamblers but loudly proclaim the likely win – and when some lucky punter hits the jackpot, it sounds like a New Year's Eve party. As a build-up to this, each coin makes its own little tinkle when it hits the tray and the slot machine 'talks' to participants as they play. It gives the impression that everyone is winning. Losses and failures are rarely publicised.

Another money illusion is called 'ignoring the base rate'. This is the tendency to disregard or discount the overall odds in a given situation. Consider the following:

Some Lotto facts

- Ticket purchasers are not interested in small prizes and they purchase at higher levels not worrying about the price hikes which come with larger prizes.
- Charity links mean consumers don't see ticket purchases as gambling.
- In the US 25 per cent of population see the best chance of saving for their retirement is lotteries.

What are the odds?

- Being killed by terrorists while travelling: 1 in 650,000.
- Royal flush opening hand: 1 in 649,739.
- Winning anything on a Lotto Lucky Dip: 1 in 20.
- Winning Lotto Division One on a Lucky Dip: 1 in 373,838.
- Winning on one Lotto ticket bought weekly for 50 years: 1 in 150.
- That you'll keep buying and not win the jackpot after 50 years: 149 in 150 (99.33 per cent).
- Winning Powerball Division One on a Power Dip: 1 in 3,070,704.
- Winning on one Power Dip ticket purchased weekly for 50 years: 1 in 1,250 (99.92 per cent don't win in all that time).
- Being hit by lightning during your life: 1 in 7500.
- Getting cancer sometime in your life: 1 in 9.
- Suffering an unprovoked shark attack: 1 in 6,000,000.
- Drowning in your bathtub: 1 in 685,000.
- Dying in a car crash in New Zealand: 1 in 9000.
- Dying from slipping, stumbling or tripping: 1 in 6548.
- Dying from fireworks discharge: 1 in 615,488.

Obviously the chances of winning lotto are not high, but people still persist in buying tickets.

Do you do this?

You exhibit overconfidence if:

- You think you are beating the market consistently.
- You claim credit for profits but explain away losses.
- You make investments or spend without much research, or you have numerous financial information sources.
- Your trade frequently.
- You don't know the return on your investments.
- You think you should invest in 'what you know'.
- You think investing without an advisor is smart and easy.
- You are willing to take large risks.
- You invest heavily in one market or sector.
- You disregard indicators that do not endorse your position.
- You are willing to ride losses.
- Your 'let's take a chance' attitude increases.
- You believe that the best is yet to come.

3

Pride and Regret

'Pride goeth before a fall.

– Proverbs

AVOIDING REGRET AND SEEKING PRIDE

Consider this:

Constance and Bill buy Lotto tickets every week and have done so for years. Each time they use the same set of numbers without winning. Edna, their friend, suggested a different set of numbers to give them a better chance of winning. They refused.

Clearly the likelihood of a new set of numbers winning is the same as that of the old set. Why won't they change numbers? Because of the likelihood of regret. If they stick with the old numbers and the new numbers win, they will regret not changing. If they select the new numbers and the old numbers win, they will regret their actions. The regret in the latter instance would be the stronger – they had a lot of emotional capital tied up in the old numbers.

If, however, Constance and Bill won Lotto with either set of numbers, deciding to keep the old numbers or making the decision to switch would be a source of pride.

Avoiding regret and seeking actions in which we can take pride is a normal function of the human psyche. Regret is the emotional pain that comes with facing the fact that a previous decision turned out to be a bad one, pride is the emotional joy of realising that a decision turned out well. As I write this, the receivership of Provisional Finance is in progress.

Failed Bid to Save Financier Riles Investors

From the *Southland Times* – 12 June 2006

The man would not disclose specifics on his investment, only to say he had 'thousands' with the company.

He was disappointed it hadn't been made known to him that Provincial was in the South Auckland car loan business.

'We have got money in other finance companies, too, and I'm worried about those as well. I'm starting to wonder if they are safe....'

Investors spoken to said they would be looking seriously at whether they would continue to put their money into finance companies.

As you see, the unnamed investor is exhibiting regret at the decision he made to invest in Provincial and, furthermore, given his experience with Provincial, he is seriously rethinking his investments in finance companies. This is displaying another investment trait that we will discuss more fully later.

Or consider the Access collapse.

Access Customers Slow to Claim Funds

From the *Christchurch Press* – 15 October 2004

The liquidators of collapsed sharebroker Access Brokerage say more than half of the customers owed money have yet to claim it.

Liquidator Brendon Gibson said his firm, Ferrior Hodgson, would be sending reminders to about 5000 former Access customers over the next few days, plus placing advertisements in all the big daily newspapers for people to get in touch.

‘There are a handful who are owed as much as \$70,000 and we’d really like to get their funds back in their hands’, he said....

‘We’re a little surprised that we haven’t got to 70 or 80 per cent by number.’

By claiming the money, the investors have to accept that they made an unsound decision, which they would regret. So they take no action. Mr Gibson, the liquidator, should not have been at all surprised, Access’s customers were exhibiting normal behaviour.

Let’s consider the regret/pride continuum more fully. Imagine yourself in this situation:

- 1 You have a share portfolio which you are managing yourself.
- 2 A new float appears, and you decide it will be a great investment.
- 3 You have no additional funds available for this investment so you have to sell some shares.
- 4 Do you sell your shares in brainiac.com which have gone up 20 per cent since you bought them, or do you sell the shares in Sillybilly Limited which have gone down 20 per cent?

‘Uh huh’, you say, ‘I know the answer, I would sell Brainiac.’ It has made a profit and you should lock in profits, but underlying this decision is the pride you will feel in selling and in making a profitable sale, validating your brilliant decision. You don’t sell Sillybilly Limited as this would engender the pain of regret, your decision to purchase it was not a good decision.

THE DISPOSITION EFFECT

Why is it a problem to sell your winners rather than your losers? Studies have found that investors have a strong tendency to hold losers too long and dispose of their winners, this is known as ‘the disposition effect’. This behaviour does not appear to be motivated by a desire to rebalance their portfolios, nor is it justified by subsequent portfolio performance. Investors believe that their current losers will, in the future, outperform their current winners.

There is also a correlation between the length of time a share is held in an investor’s portfolio, and the return received. A share that increases in value quickly is more likely to be sold quickly, as opposed to one that goes down or remains level. Therefore, shares owned for a short period of time tend to be winners and shares held for a longer period are more likely to be losers. On average, investors are 50 per cent more likely to sell a winner than a loser. They feel the pain of loss more strongly than the pleasure of gain. That is, you would feel the misery of losing \$100 (or \$1000 or \$1 million), about twice as strongly according to the studies, more than the pleasure of gaining the same amount.

Gentle reader, you may postulate that the tendency to weigh losses more heavily than gains is not entirely a bad thing, loss aversion can be helpful and conservative. Sensitivity to loss can, however, skew judgement in investing. Consider the situation of a market crash. The aversion to loss makes most investors overreact and panic, selling shares, driving prices down, compounding market losses and causing pain – which is not assuaged as you watch prices rise while you are licking your wounds. Having an advisor at this point can be useful. You can lower the level of regret by blaming her if the investment turns out badly. If it turns out well, then we can give ourselves the credit.

The stockmarket is much like war: Long periods of boredom interrupted by episodes of pure terror.

Fear of regret and making a loss applies not only to investments in assets such as stocks and bonds but also to the housing market. Consider Rose’s story.

Case study

Rose purchased a home for \$420,000 in the early 1990s just before a decline in the housing market. A year later she shifted to Australia to take a better job. She didn’t take any of the offers for her home, ranging around the \$380,000 mark, for the next two-and-a-half years, all the while the market continued to drift down. She finally sold her property for \$305,000. In the meantime she paid rental and

watched the property costs in her preferred area increase. She estimates her delay costs to be not only \$115,000 in New Zealand dollars, but around \$90,000 in Australia as she delayed purchasing.

Her overdeveloped fear of loss cost her a great deal of money.

THE EFFECTS OF THE MEDIA

The media and company reporting affect how we trade. Investors react differently to news about companies (the ones in which they have invested) and news about the economy; obviously company-specific news affects the price of its related share, whereas news about the economy affects all of the market. Good news about a firm that increases the stock price induces investors to sell (selling winners). In contrast, bad news about a firm does not induce investors to sell (holding losers). Investors are avoiding regret and seeking pride.

In contrast, news about the economy does not induce investor trading. Although good economic news increases share prices and bad economic news decreases share prices, this does not cause individual investors to sell. In fact, investors are less likely than usual to sell winners after good economic news.

This exposes an interesting characteristic of regret: when taking a loss investors feel more regret if the loss can be tied to their own decision.

REFERENCE POINTS

One of the most important factors in determining whether you have made a profit or loss is the reference point you utilise. This point of calculation is a major factor in framing the positive or negative assessment of our investment – the same outcome can often be described as a gain or a loss. Consider this:

Case study

Joanna has bought shares in Solidas Co at \$5 a share in January. The following January her shares are trading at \$10 a share. Six months later Joanna sold her shares for \$7.50 each. She has made a profit of \$2.50 per share, however, the profit is lower than if she had sold six months previously. Joanna has obviously made \$2.50 per share, but does she feel like she has made a profit or a loss?

The reference point is the point at which we compare the price at sale to either the purchase price of \$5 or the 12 month subsequent price of \$10. If \$10 is Joanna's reference point she has made a loss of \$2.50 per share; if it is the purchase price of \$5, clearly she has made a profit of \$2.50 per share. The brain's choice of reference point is important because it determines whether you feel the pleasure from

making a profit or the pain of taking a loss.

Early studies into investment psychology assumed that the reference point would relate to the purchase price. In practice, however, investors usually monitor price and performance over the period of a year. From this it follows that, as investors, we periodically update the reference points to reflect unrealised profits. So where does this leave Joanna? She will feel she has made a loss as she updated her reference point to the \$10 value, so rather than feeling pride at her good investment decision, she feels regret at taking a loss.

FRAMING

Let's move from the world of money and examine the results of the following study taken from the field of medicine.

Two groups of doctors were given a scenario in which a patient who had a serious disease had the opportunity to embark upon a new form of treatment. The only difference in the evidence presented to the medics was in the way the case was presented, or 'framed'. One group was told that 7 per cent of patients who had this treatment were likely to die within five years; the other group was told that the patients had a 93 per cent chance of survival. The 'framing' of one prognosis was negative and the other positive. The first group were disinclined to recommend the treatment, the framing of the problem encouraged them to think about departure from the baseline of good health (7 per cent mortality rate) while the second group were encouraged to think about proximity to the baseline – continued good health.

The good doctors, like the rest of humanity, focus on how far we move away from a mental starting point.

One of the things that always intrigues me is the way some financial institutions do their marketing. Their advertisements may say something like, 'Invest in this fund – it earned 16 per cent last year', but they neglect to point out that the market went up 22 per cent last year. This frame also takes their one year return out of context. There is no appropriate baseline from which to measure the fund's performance. Another variation on this theme may be where the advertising financial institution selects an inappropriate baseline. For example, a sharemarket fund could be compared to a fixed-interest fund; the fixed-interest fund will under perform a sharemarket linked fund.

This highlights an important feature of human judgement, namely that responses are *constructed on the spot* and the response will depend on *how the issue is framed*.

We make many choices where the outcome is uncertain: during the rugby season do we bet on our favourite football team? Do we drive

through the amber light? Where should our retirement funds be invested?

Do you do this?

Your financial life is afflicted by pride and regret if:

- You make important choices in spending or invest based on how much you have already outlaid.
- You generally prefer 'safe' investments, like term deposits rather than shares.
- You sell winners 'to lock in profits' rather than sell losing investments.
- You take money out of the sharemarket (or are tempted to) when prices fall.
- You don't sell losing investments because you believe they will recover.
- You use naïve diversification – a loss hurts less if it is combined with some gains.
- You talk long-term but act short-term.

Considering the Past

'The four most dangerous words in investing are "this time it's different".'

– Sir John Templeton

HOUSE MONEY EFFECT

An apocryphal tale: the legend of the man in the green bathrobe.

By the third day of their honeymoon in Las Vegas the newlyweds had lost their \$1,000 gambling allowance. That night the groom noticed a glowing object on the dresser. Upon closer inspection he realised it was a \$5 chip they had saved as a souvenir. The number 17 was flashing on the chip's face. Taking this as an omen, he put on his green bathrobe and rushed down to the roulette table where, not surprisingly, he bet on number 17. He let his winnings ride and eventually he was worth \$7.5 million. Unfortunately the floor manager intervened, claiming the casino didn't have the money to pay should 17 win again. Not to be deterred, the groom caught a taxi to another casino where he bet all on 17 again, when it hit it was worth \$262 million. Needless to say, with such luck he bet again, only to lose it all when the ball fell on 18. Broke and dejected, the groom walked the several miles back to his hotel.

'Where were you?' asked his wife.

'Playing roulette!' he replied.

'How did you do?'

'Not bad, I lost \$5.'

The groom felt that his winnings were not real money, and so the losses were not real losses. This tale told in some parts of Nevada as gospel truth demonstrates one of the most common and costly money mistakes: our tendency to value some dollars less than others and to waste them.

After people have experienced a gain or a profit they are willing to take more risks. Gamblers refer to this feeling as playing with the house money.

As you will know by now, I am unable to resist giving advice, so read the following:

Wagering wisely

- Beware of the tendency to tell yourself that you must recoup your losses. This drags you further into the hole and perpetuates the obsessive aspect of gambling.
- Argue with the instinct that you can beat the system by reminding yourself of the statistical realities.
- Place restrictions on your wagering before you get sucked in. The rush you get from gambling is fun and often legal, but beware of your judgement while 'in the zone'. Leave your credit card in a safe place and do not let it into the casino.
- Your instinct for risk generally operates below the level of conscious awareness. Talk about the fun of gambling – so that you control the gambling, rather than the other way around.
- If these suggestions don't help, place it all on 21 Red (I have a hunch). No, make that 21 Black.

One area in which we seem to be especially irrational is in judgements of and responses to risk. Our perception of risk can be at odds with an analytical assessment of data. For example, we may be disproportionately afraid of risks for which there is little evidence, for example, tsunamis, while underrating the proven dangers of cigarette smoking or drink driving. We are sometimes poor at learning and understanding probabilities. Mull over the following example.

Consider this: Suppose you were told a man comes from a group consisting of 70 per cent lawyers and 30 per cent engineers. If you were asked how likely it was he was a lawyer, you would say 70 per cent, the base rate. Suppose in addition to this you were told 'he is very practical and enjoys servicing his own cars'. This will make you more likely to assume he is an engineer. However, the base rate hasn't changed, the probability that the man is a lawyer is still 70 per cent.

Probability and risk-taking are inextricably linked in the world of investments. There is no guarantee that any asset will thrive in the future. This leaves you with two options if you aren't planning for a short retirement.

- 1 Keep your money in a sock under your bed and hope you save enough to last you through retirement.

Or:

- 2 Take some risk and invest your money in assets that have a reasonable chance of making you a profit.

And if you have been unfortunate enough to have made a financial loss in the past, take care that the snake-bite effect doesn't prevail – once bitten, twice shy.

ENDOWMENT OR STATUS QUO BIAS

Alternatively, like gamblers, investors can exhibit the desire to 'at least break even'. Losers don't always avoid risk and can jump at the chance to make up losses.

Consider this: You live in a house that is exactly the same as that of your next-door neighbour. Your next-door neighbour decides to sell. You consider the price she is asking and come to the pleasant conclusion that although the properties are no different, yours is worth more. Why is this?

We often ask for much more to sell an object than we would pay to purchase it. This is called the endowment effect – meaning anything we own is immediately endowed with additional value. A closely related behaviour is known as the status quo effect – that is our tendency to keep what we have been given instead of exchanging it.

A foot in the door

Marketers understand the endowment effect all too well. Why do you think so many retailers or product providers offer trial periods and money-back guarantees? Once you take that garment or lounge suite home there is an extremely strong chance the endowment effect will kick in.

Your prospective lawyer or accountant offers you a free consultation, or your insurance company offers a free-look period. Once you have spoken with your potential advisor or had your new policy a day or so, the value you originally placed on these will increase.

So next time you consider 'trying out' products or services, reconsider while you can; the chances are you won't return it after it is in your possession!

Placing an inordinately high value on what we have makes it difficult to change. We can overcome this tendency, after all we change cars, sell homes and divorce spouses. As investors, however, we need to be aware of this behaviour, in that it makes it doubly difficult to properly value what is and isn't yours. And you may thus fail to pursue options that are in your best interest, by placing too much emphasis on what you would pay now, and placing too little value on opportunity costs: that is what we miss by not taking an action.

Case study

Wilhemina came into a large inheritance. Her new funds were invested in nine high-risk companies and 11 different junk bonds. Wilhemina was 78 years of age and had her own money invested in savings accounts in her local bank. Amazingly, she made no changes to the portfolio she inherited.

Wilhemina's actions demonstrated the status quo bias – the bias increases as the number of investment options increased. That is, the

more complicated the decision, the more likely we are to do nothing. In the real world we are faced with the choice of investing in thousands of shares, bonds, managed funds, superannuation funds and so on. All of these choices overwhelm investors, and as a result we often avoid making a change.

ANCHORING

Consider this: You buy shares in two companies, one in Greengrass Limited, a farm supplies company, and the other in Robocorp Limited, a nanotechnology company. Each share costs \$10. Shares in Greengrass Limited slowly decline over a 12 month period to \$7.50. At the end of the 12 month period the shares in Robocorp Limited suddenly plunge to \$8.00.

Over the year the shares lost value in different ways: Greengrass Ltd shares drifted down in value, whereas the nanotechnology company experienced a dramatic loss at the end of the 12 month period. Which loss will affect you the most?

The memory of the dramatic drop in value in Robocorp is the one which you will associate with a high degree of emotional pain. The slow loss provides less emotional pain, even though the farming company turned in a worse performance. As an investor you would, therefore, be less optimistic about the future growth of Robocorp. The same pattern occurs for pleasurable experiences.

Consider this: Both stocks increase in price, one slowly and the other dramatically. The shares that show a sudden rise in value are the ones investors favour.

One of the behaviours that help us rewrite history is known as 'anchoring'. We 'anchor' judgements by clinging to a fact or figure that can skew our memory, and thus our decision-making. And, as a result, we make financial decisions based on incomplete and inaccurate information. Gentle reader, I am sure you know someone who, once they get an idea in their head, avoids asking questions that may challenge their preconceptions. You will be able to observe that this attitude has profound implications on any decisions regarding how to spend, save, borrow or invest.

MENTAL CONFLICT

Psychologists have studied the consequences of memory problems. Typically, we judge ourselves to be 'intelligent and kind'. If we experience evidence that contradicts this view, we struggle with two seemingly opposite ideas. For example, the memory of a past action could suggest that you are not kind. This conflicting feeling is called cognitive dissonance. To avoid this mental discomfort we ignore,

reject or minimise anything that conflicts with our positive self-image. Evidence that cannot be denied is accommodated by a change in beliefs; we always want to feel like we have made the right decision.

This mental conflict can also affect decision-making: we can fail to make important decisions because it is too uncomfortable to contemplate. In addition to this, investors can seek to reduce any psychological pain by adjusting their beliefs about the success of past investment choices. Consider, for example, the investor who has a managed fund. Over the period of investment the fund's performance will either validate or put into question the investor's wisdom in making the decision. To reduce mental conflict the investor's brain will filter out or reduce negative information and fixate on positive information. In effect, the investor's memory of past performance is better than the actual past performance. Why? We want to see ourselves as good investors, so our memory adjusts reality to align with that self-image.

HOW THESE EFFECTS MAKE FINANCIAL CHOICES DIFFICULT

Gentle reader, you are probably at the point of thinking, why bother? But wait, there is more! Decision paralysis could be rearing its ugly head. Remember Wilhemina and the number of investments she inherited? She maintained the status quo. When we are faced with myriad choices we frequently decide not to make a decision which is, of course, a decision in itself. Deferring financial decisions may mean that you miss making a profit. Decision paralysis helps explain why so many people faced with the many fund choices available default to the 'wait and see' or 'safe' option of a balanced or conservative fund; or stash money in a bank. Studies have shown, however, that the longer you defer making a decision, the less likely you are to overcome your hesitation.

Indecision is typically overcome when we feel we have a sound reason for choosing one option over the other. If you are struggling with decision paralysis, take up Benjamin Franklin's excellent suggestion, write lists for the pros and cons. Alternatively, narrow the field by selecting the actions you don't want and then rank the options remaining in order of preference.

Have you exhibited any of the following behaviours in the past? If so, make a vow never to repeat them. (Most people exhibit one or two of these behaviours. If you do, examine these instances in a calm and rational way.)

- 1 No financial plan, or if you have one, no exit strategy.
- 2 Deciding not to decide.

- 3 Investing too aggressively.
- 4 Investing too cautiously.
- 5 Believing publicity.
- 6 Not understanding how to minimise your bank fees.
- 7 Being a perfectionist.
- 8 Not obtaining advice from professionals.
- 9 Greed and fear drive markets. Do you let them drive your financial decision-making?
- 10 Believing recent performance is an indicator of future performance.
- 11 Having unresolved money issues with partner.
- 12 Educating yourself about investments.
- 13 Focusing on money and investments to the extent that your personal and social life suffers.

And 13 is an unlucky number. It is possible that it is costing you money to delay making decisions. Consider the following.

Do you do this?

- You leave money in a bank account rather than putting the cash in an investment with higher returns.
- Staying in your comfortable low-paying job rather than making the switch to one with a higher salary.
- Failing to sell an investment, only to see it drop in price.
- Keeping revolving balances on a high credit-card rate, rather than switching to one with lower finance charges.
- You buy things on free trial and even if you change your mind you don't return them.
- You beat yourself up when you make bad decisions.
- You delay making investment/spending decisions.
- You fear a never-ending bear market – that persistent myth.

Mental Accounting

'It's clearly a budget.
It's got a lot of numbers in it.'

– President George W.
Bush

MENTAL ACCOUNTING

We are familiar with the concept of accounting, structures that track, separate and categorise the flow of money used by households, businesses, governments, charitable organisations, and so on. Our brains do the same thing. You may not be aware of it, but every decision, action and outcome is recorded and filed. As we saw in the previous chapter, once we have formed a view we rarely change it.

The term mental accounting sounds complex and a little off-putting. It is simple, however, and refers to the way we think about our money and compartmentalise the various financial activities we undertake. Our brain does the mental equivalent of our grandmother's separate tins that were earmarked for specific expenditures. There are three components of mental accounting:

- 1 How we perceive the results of expenditures and savings, how we make and evaluate our decisions.
- 2 Like our grandmother's tins we have specific accounts which detail the source of our money and the use to which that money is put: mortgage payments, retirement savings, or holiday savings.
- 3 The frequency with which we visit and evaluate the success or otherwise of our *accounts* – weekly, daily, monthly or yearly.

Mental accounting is not neutral, that is, it is affected by our money psychology. We treat the dollars in our mental accounts differently. Each dollar is not equal, we don't perceive money as 'fungible', in other words the ability money has to be converted into any commodity.

Mental accounting is piecemeal in nature, we evaluate transactions one at a time rather than as a whole – this is why each of us needs a coherent financial plan.

We identify gains and losses relative to an arbitrary reference point. Both gains and losses display diminishing sensitivity. For example, the difference between \$10 and \$20 seems bigger than the difference between \$1,000 and \$1,010. But \$10 is still \$10. The loss of \$100 hurts more than the pleasure of gaining \$100.

Opening and Closing Accounts

One of the choices we make with our mental accounting is when to leave our accounts open or when to close them. Take the example of 100 shares bought at \$10 per share. The original investment is \$1,000 but this will go up or down as the share price fluctuates, thus the investor has a paper loss or gain until the shares are sold.

Rational thought would dictate that the investor would sell the loser, but mental accounting favours selling the winner.

Mental accounting in relation to our credit cards could be called creative accounting. Credit cards separate payment for goods from ownership of the items we acquire. Payment for purchases is made later, if you are not handling your card payments properly, at a greater cost than that of the original purchase price.

Furthermore, if we use cash rather than a card, our memory of the cost is more likely to be accurate. When several purchases are listed on a statement, our eye immediately goes to the total amount owing, not the cost of individual items.

Mental Budgeting

Money is commonly labelled at three levels:

- ☐ Expenditures are grouped into budgets (eg. food, housing).
- ☐ Wealth is allocated into accounts (eg. cheque, passion, rainy day).
- ☐ Income is divided into categories (regular or windfall).

We don't treat the funds in our separate accounts as interchangeable, by that I mean we don't swap money in our budget account with funds in our wealth account. We treat our income differently from that money won on the pokies.

Consumption Categories

If we think carefully about how we treat our consumption categories we can make trade-offs between competing uses for funds. We can also categorise to assist us in self-control by putting money in accounts which are off limits.

The easiest and most tempting accounts to access are the cash or cheque accounts. Less tempting and not so easy to access, is the wealth category, eg. shares or managed funds. Also in the hierarchy is home equity, which is rarely utilised as a source of funds.

Finally, the least tempting category is the future earnings account – money that will be earned later in life and retirement savings.

It may interest you to know that those canny investors who contribute to retirement savings plans display steady increases in their retirement accounts with no apparent reduction in the funds held in their other accounts. That is, they save more and still have expenditures in the same categories as those people who are not saving. This is a good argument for starting your retirement fund.

A piece of good advice

I suggest to my clients that they use cash only, not ATM cards or credit cards. This helps control spending.

INCOME ACCOUNTING

Mental accounting applies to income as well as savings and expenditure.

Winnings are frivolous and income tax refund is serious. Eating out is frivolous, but paying bills is serious. People have a tendency to match the seriousness of a windfall with its use.

Consider this: Friends of mine, John and Jenny (names have been changed to protect the not so innocent), saved \$15,000 towards their dream holiday home that they hope to purchase in around five years. They earn 4 per cent in their savings account. They have just bought a new car for \$11,000 which they financed with a three-year loan at 9 per cent. Why?

This is a common failing. I often talk to people who have done just this, they put money in a savings account that earns a low rate of return and borrow at a high rate. If they had borrowed the funds for the car from their savings account and paid themselves 9 per cent, their dream holiday home account would have been more than \$1,000 higher at the end of three years. The problem for John and Jenny was that their saved money was in a separate mental account than that of financing a new car.

Mental accounting is the process we use to categorise and treat money differently depending on where it comes from, where it is kept or how it is spent. This leads us to value some dollars less than others, and thus to waste them.

Consider this: Winning \$100 on the pokies, obtaining a \$100 tax refund or \$100 in salary should have the same significance and value to you – no matter which \$100 you spend you will still have only \$100 worth of products. Each financial decision should result from a rational calculation of its effect on our wealth. We are, however, not

computers. It would be a difficult intellectual exercise and emotionally demanding to calculate the cost of every financial transaction we make. Buying a cup of coffee or going to the movies, going to the supermarket or buying a home: in order to cope with this complexity we separate our money into different accounts with different levels of significance.

This is not a bad thing, it can be logical and rational – it can allow you to save effectively for future goals. John and Jenny, for example, did not consider touching their ‘home savings’.

John and Jenny displayed the same failings as many investors. When deciding to finance their new car they did not knock down the mental walls between their accounts. Investors, when attempting to balance and evaluate their portfolios, often display the same behaviour. The portfolio balance – their combination of shares, government stock, real estate managed funds and so on – is often not appropriate, and investment performance suffers.

Investors frequently hold over conservative portfolios because they focus on short-term losses, thus often have too little invested in equities and too much in fixed interest. Loss is partly perception and is subject to framing. Consider reframing, as Forest Gump said: if someone hands you lemons, make lemonade.

MATCHING COST TO BENEFIT

One of the features of mental accounting is matching cost to benefit – usually we prefer the ‘pay-as-you-go’ system. Marketers who think long and hard about how to separate us from our money understand this very well. There are few retail outlets who do not offer ‘pay-as-you-go’ options whether interest free or not. You can buy that leather lounge suite now and pay for it while you are enjoying the use of it – but, make sure it is an interest free loan! And do not pay any establishment fees, additional insurance premium or, in the case of appliances, extended warranties. The devil is in the detail.

Consider this: You have decided to take a well earned holiday which will cost \$1,200. You have two options for financing the holiday:

- 1 Six monthly payments of \$200 each during the six months prior to the holiday.
- 2 Six monthly payments of \$200 each during the six months beginning after you return.

As you are astute you will have picked up on the fact that both the suggested payment options are the same in time and dollars value. The only difference is when the payments start. Interestingly, over 60

per cent of the respondents to this survey chose Option 1. Option 2 is, of course, cheaper, because of the erosion of the value of money due to inflation. Those who chose Option 1 did so because they believed a prepaid holiday was more pleasurable as the pain of payment was over. An important factor in the prepay or finance decision is the level of pleasure expected to be generated by the purchase.

We tend to have an aversion to debt if the product or service we have purchased is consumed quickly – thus, pre-financing homes, cars and TVs is popular, financing holidays is not.

Case study

The Great Savings Dilemma

Babette is a high income earner, on a salary of \$80,000 with a bonus of around \$20,000 a year, yet she can't seem to save enough. She doesn't carry credit-card debt or hire purchases. She is meticulous and cost conscious, she reports, when she buys a house, car or any big ticket items. She confesses, however, that she does not pay attention to what she spends on clothes, entertainment or food. The problem is that while the big-ticket items are purchased maybe every few years, her discretionary expenses are clocked up every day of every week. Being cost conscious when making little purchases is where she can rack up big savings.

Sample spending budget

Small expenses add up!

Lunch @ \$5 per day = \$35 per week = \$1820 per year

1 coffee @ \$3 per day = \$21 per week = \$1092 per year

Movies @ \$12 per visit once a week = \$624 per year

Dinner out once a week @ \$40 = \$2080 per year

1 bottle of wine once a week @ \$15 = \$780 per year

clothes @ \$200 per month = \$2400 per year

... a total expenditure of \$8796 from Babette's after-tax income.

Some fund managers are very aware of our tendency to loss aversion. They market products that guarantee a return of capital and participation in profits (if the manager makes any) which is like having your cake and eating it too.

As children we partake in the simplest forms of learning: we repeat behaviours associated with pleasure and refrain from behaviours associated with pain – if it burns we don't touch it again. As investors we employ the same patterns of learning. The problem for us is that investing for profit is less than clear cut, and as avoiding pain is a primal instinct, we don't react rationally. In fact, one study showed that investors are twice as likely to repurchase shares that have treated them well, and shy away from those that have put them in a

loss situation.

THE SUNK COST FALLACY

Another form of mental accounting we are prone to is the sunk cost fallacy. Previously, economists theorised that we consider the present and future costs and benefits when determining a course of action. Past costs or money already spent, or 'sunk', should not be a factor but, gentle reader, you and I both know we are not rational beings. We routinely consider historic, non-recoverable costs when making decisions about the future.

Consider this: You have been given free tickets to the rugby World Cup. You are really looking forward to going as the All Blacks are the favoured finalists. Before you leave you find that your favourite forward has been injured and will not be playing. Plus a sudden snowstorm makes the trip to the game unpleasant and somewhat dangerous.

Now, imagine this: You have paid the scalpers a small fortune for the ticket and there is no chance of selling the ticket to anyone else.

Most people choose to travel if they have paid for the ticket while foregoing the trip if they had been given the ticket for free. The distinction is nonsensical of course – the money for the ticket is spent, or 'sunk', in either case you won't get it back whether you go, or watch the game on television. As a matter of fact, the game may incur extra costs, you may have an accident, be seriously injured or die. The danger posed by the snowstorm of the century is there whether or not you paid for the ticket.

One of the more interesting suggestions researchers make is that we fall prey to the sunk cost fallacy because we don't want to appear wasteful – not necessarily to other people but to our own internal monitor. Remember cognitive dissonance? We want to view our actions as financially astute.

It is clear that we are willing to incur costs as a result of mental accounting, sometimes prepaying for products or services and, thus, not taking advantage of the time value of money. That is, the idea that money available at the present time is worth more than the same amount in the future, due to its potential earning capacity. Remember our holiday payment example? Mental accounting causes us to match the emotional costs with the benefits of a purchase. So where does this leave us as investors?

It has been demonstrated that investors tend to place each investment in a separate mental account. Remember that investors avoid selling losing shares or investments because they do not want to experience the emotional pain of regret. Selling the losing stock closes the mental account, triggering regret. Mental accounting compounds

the aversion to selling losers. As time passes the cost price of the share becomes a sunk cost. It may be less emotionally distressing for the investor to sell the losing share later as opposed to earlier.

When investors do decide to sell losers they have a tendency to bundle more than one sale on the day, in order to minimise their regret. Conversely, investors like to separate the sale of winners over several days to prolong the enjoyment and pride in selling winners.

FRAMING AND MENTAL ACCOUNTING

The narrow framing aspect of mental accounting might also explain why most people do not invest in the sharemarket even though shares have a high average return. When a long-term horizon is imposed we select more risk. A recent study showed some investors a single year of share returns in a lack-lustre year and that of a secure fixed-interest investment of government stock. The majority of investors selected government stock. However, other investors were shown long-term sharemarket versus government stock returns, and 90 per cent invested in shares. Narrow framing means we tend to evaluate projects one at a time rather than as an aspect of an overall portfolio – this tendency can lead to an extreme unwillingness to take risks.

Stocks have outperformed bonds over the last century by a surprisingly large margin. There is an enormous discrepancy between the returns on stocks and fixed-income securities. Since 1926 the real return is 7 per cent on stocks, and the real return on bonds is less than 1 per cent (1995).

Two factors contribute to an investor being unwilling to bear the risk of holding equities: loss aversion and a short evaluation period.

Loss aversion refers to the tendency of individuals to be more sensitive to reductions in their levels of well-being than to increases.

The attractiveness of the risky asset will depend on the time horizon of the investor – the longer the investor tends to hold the asset the more attractive the risky asset will appear, so long as the asset is not evaluated frequently.

How can investors be extremely unwilling to accept variations in returns, as the equity premium implies, and yet be willing to delay consumption to earn a measly 1 per cent per year? As you read this book I am sure the reasons are becoming clear.

Do you do this?

- You make important spending decisions based on how much you've already spent.
- You tend to sell winning investments more readily than losing ones.

- You are seriously tempted to take money out of the share market when prices fall.
- You generally prefer government stock over shares.

Representativeness and Familiarity

'Familiarity breeds contempt.'

– Anon

REPRESENTATIVENESS

Does familiarity breed contempt? No, according to studies. Our brains, those wonderfully efficient machines, use shortcuts to reduce the complexity of analysing information. It is these shortcuts that drive the brain actually to generate an answer to a problem before fully digesting all the facts. Two of these 'shortcuts' are called representativeness and familiarity.

Representativeness is the assumption the brain makes that things which share similar qualities are alike – it is our capacity to think in stereotypes.

Consider this: Miss Perkins is quiet, studious and concerned with social issues. She has an Honours degree in English and a Diploma in Environmental Studies.

Given this information, which of the following statements is the most likely:

- a) Miss Perkins is a librarian.
- b) Miss Perkins is a librarian and a Greenpeace member.
- c) Miss Perkins is a banker.

In practice, when asked this, more than half of the respondents chose 'b) Miss Perkins is a librarian and a Greenpeace member.' This answer is selected because it is the sort of career we think is most likely to be selected by a studious person concerned with the environment. Around 25 per cent of respondents selected 'a) Miss Perkins is a librarian', understanding that b) is a variant (or subset a)).

However more people are employed by banks than by libraries. Our brains select against c), because the banking industry is not what we think of as 'representative' of someone with Miss Perkins's skills and interests.

So how does this 'representativeness' affect investors? We confuse a

‘good’ company with a ‘good’ investment. Remember Colin Meads saying Provincial Finance was ‘solid as?’ Many investors then thought Provincial was a ‘good’ company. Among other things, a good company can be defined as one which generates strong earnings, and has a good level of sales growth and quality management.

There is a clearly defined pattern when investing in good companies. When we invest in a good company we expect the high levels of growth to continue, but few companies can sustain long periods of high growth. We invest in a good company, the popularity of these shares drives prices higher, but, over time, it becomes apparent that investors have been too optimistic in predicting future growth and the price falls.

Shares in these firms are labelled ‘glamour’ shares. Shares in firms that investors typically consider to be bad firms with minimal growth prospects are labelled ‘value’ shares. And, yes, I know some of the ‘value’ firms could be dogs, but bear with me for the sake of argument. Ask yourself: glamour or value? Which shares will be the better investments over the next year, the next five years? At the risk of repeating myself, the past growth of a firm is not ‘representative’ of the future performance of that firm and many investors ignore information that does not fit that notion. Good companies do not perform well forever, just as bad companies do not perform poorly forever.

So, although you are nodding sagely at this point, I am willing to bet that you like to chase winners and buy shares that have already trended upwards in price. However, smarter people than you and I, who have done in-depth studies on buying losers versus buying winners, have calculated that losers tend to outperform winners over three years by a massive 30 per cent. And whatsmore, if you are reading this as a managed fund investor, you have probably made the same extrapolating error. When fund managers advertise or list recent high performance, they enjoy a flood of new investors.

In fact, this type of investing is so prevalent it has its own name: Momentum Investing. Momentum investors look for shares or funds which have performed well over the past week, month, quarter or year – and the media feed – that bias.

Don’t feel, however, that you are the only investor silly enough to act this way. A series of surveys of financial economic professors concluded that their estimates were consistent with the notion that the most recent past is representative of what will happen in the future – you’d think they would know better?

In short, investors interpret past performance as representative of future performance and I have not yet met an investor who acts differently – despite all the warnings that historical performance does

not guarantee future returns. In practice, firms tend to revert to the mean over the long-term as competition increases and slows their rate of growth. Investors then find that their investment does not perform as expected.

We all like the comfort of familiarity – when we are faced with choices and we know more about one than the other, we select the more familiar option. In this way we root for our local sports teams, or invest in a company with whom we are familiar. Faced with innumerable potential choices in shares and bonds here and offshore, how do we choose? We invest in the companies or government stock with which we are familiar rather than analysing the risk and return of our potential investments. We opt for the comfort of having an investment that is visible. Interestingly this applies not only to us as individual investors, but to fund managers as well. Examine the portfolio breakdown of a diversified fund and you find a large New Zealand sharemarket exposure. Given that our market is less than 2 per cent of the world market that goes against the traditional ideas of diversification. We have a ‘home bias’ because companies from our own country are more familiar to us than those of foreign companies.

FAMILIARITY

The Perils of Investing Too Close to Home

When we do invest in foreign companies, what do we normally buy? Yes, you have guessed it: familiar foreign firms, that is large firms with recognisable products. In fact, a recent study analysing this phenomenon clearly shows that investors do not follow modern portfolio theory in that if they did they would own more foreign equities.

Again, interestingly, the same bias is found in fund managers. Those from continental Europe predict that their domestic share market will perform better than those of the UK, the US and Japan. At the same time managers in the UK predict their domestic returns will be highest. Thus, they are more confident and optimistic in the shares with which they are familiar and too pessimistic about the equities with which they are not familiar.

Take the example of a well-known US company, Coca-Cola, whose headquarters are in Atlanta, Georgia. Investors living in Georgia own 16 per cent of Coca-Cola and, furthermore, the majority of investors live in Atlanta. Coke sells its products worldwide but the people most familiar with the company own the largest percentage of it.

By now you will be aware that when you are familiar with something you have a distorted perception of it. Fans of the All Blacks, for example, think they have a higher chance of winning than any

opposition team.

The reason we like familiarity when we invest is simple. There are limits to the amount of information we can process – it is difficult to rank hundreds of options, let alone the thousands available. We, therefore, reduce the options we consider by only looking at those we are familiar with; depending on our preferences. Contrarian investors, for example, will tend to buy out-of-favour stocks that catch their eye, while momentum investors will chase recent performers.

Consider this: Your friend Karina has just bought an investment property as a retirement home. In her opinion, property is the best investment you can make and will give her a great return at no risk. She avoids all other forms of investments. She has watched the growth in the property market over the last five years and is sure that it will continue.

What does this scenario tell you? Karina already owns her home so she is ‘familiar’ with property, the recent returns from property have been good so she expects that to be ‘representative’ of future returns.

In addition to this, like many investors she has not considered modern portfolio theory. Modern portfolio theory suggests that investors should diversify investment assets by selecting from shares, government stock and money market assets. Investing in one sector only is not practising diversification. (See Chapter Ten for more information on this.)

FAMILIARITY BREEDS INVESTMENT PROBLEMS

What company are you most familiar with? My guess is the company you work for. Frequently this familiarity causes us to invest in company shares. This, of course, is not necessarily a bad thing, but consider your labour risk. You will be familiar with the plight of thousands of Enron employees who not only lost their jobs in the company collapse, but their retirement funds too. If you invest in your company’s stock, take the principles of modern portfolio theory to heart. At this point investing in one’s company stock is not a big issue in New Zealand, but with KiwiSaver coming on board it will become an investment option for many of us. Health warning coming up; investing in your company’s shares could be dangerous.

Despite this, in the US where this is a common option, 42 per cent of superannuation money is invested in the company stock. Employees themselves make this decision. Overconcentrating a portfolio in only one stock is risky. However, employees do not want to believe that about their own company. The morningstar.com website asked investors this question: Which is more likely to lose half of its value, your firm or the overall sharemarket? It is far more likely that any single company would experience a larger price move than that of a

diversified portfolio or the overall market. However, of the 1000 investors who responded to the question, only 16.4 per cent of the respondents believed their employer's company was riskier than the overall sharemarket. Interestingly, investing in one's own company doesn't mean that employees as insiders have good information about their firm. Firms with high employee ownership did not perform any better, on average, than those with low employee ownership. No one company is safer than a fully diversified portfolio, like the overall stockmarket.

Our brains use the familiarity shortcut to evaluate investments. This can cause people to invest too much money in shares or assets that are most familiar to them. Ultimately, this leads to a lack of diversification.

Do you do this?

- You invest only in investments you 'know'.
- You don't have a diversified portfolio.
- You have over-invested in the asset class with which you are familiar.
- You invest mostly in domestic shares.
- You think the All Blacks will win.
- You invest in companies or funds that are the best performers.
- You go for the simplest 'on the face of it' analysis.
- You buy company shares because you know the owner/directors.
- You invest in the company where you work.
- You think a good company is a good investment.

Social Interaction and Investing

'Great minds think alike.'

– Anon

SOCIAL ENVIRONMENT

While economists continue to ask questions about our social trends, a growing academic sub-field known as economic sociology, is doing just the opposite: bringing tools and concepts from sociology to bear on the economy. Economic sociologists argue that we cannot understand how people earn, spend, and invest their money, unless we understand social relations. If, as economists contend, incentives and choice are everywhere, so are social conventions and personal connections.

Economists have long studied the markets but not the people, and sociologists are more interested in people and society rather than the market or the way we use money. However, very sensibly both groups have come to the realisation that economic behaviour and economic institutions are embedded in social relations; that is, neither economics nor sociology alone can explain how you and I manage our economic and social lives.

Sociologists argue that the economy is social: we don't divide our lives into rational or emotional, or personal and commercial segments. They suggest that our social goals are intertwined with our economic goals.

Our main source of learning is through communicating with others. The social interaction of conversation helps us gather information, detect emotional reactions, and helps form our opinions. We talk about topics that excite us, topics that interest us and even topics that worry us. One of the interesting changes we have experienced over the last couple of decades is talk about money. While we still don't share what we earn or the value of our assets, we love to give and receive investment advice. It was not so long ago that talk about investments was never heard – it was considered bad form to discuss money in a social setting.

Investing is now a social activity – investors spend a substantial

part of their leisure time discussing or reading about investments or gossiping about other's success and failures in investing. Many investors go one step further, in discussing their own investments they magnify their profits and minimise their losses. In fact, many commentators claim that these discussions may well be a dominant cause of financial movements.

INTERPERSONAL RELATIONSHIPS AND INVESTING

Like it or not we are all influenced by those around us. The most significant relationships are those where we interact with family or those with whom we have close contact, such as friends or workmates.

Family relationships are perhaps the most significant and influential. The first family relationship we enter into is that of parent and child: the apple usually doesn't fall far from the tree. Typically, parental attitudes are acquired by children. Let's examine two extremes – while you may not fit either category, you may perceive echoes in your behaviour.

The Eternal Pessimist

The eternal pessimist often reflects negative parental attitudes. The pessimist's parents were probably pragmatic, fixed in their ways, resistant to change and inflexible, reflecting a serious down-to-earth orientation in the world.

An individual who is prone to pessimism may marry someone who is similarly inclined, and develop into a super-pessimist. The attitudes of one's spouse can reinforce what you believe to be true and may, in fact, be detrimental to the overall investment result. On the other hand, a partner who is neutral or optimistic may temper or dampen the pessimist's attitude, which can arouse anxiety and create marital discord, to put it mildly. The main causes of marital break-ups are money or sex. Fortunately I should be able to help with one of these!

The Eternal Optimist

The eternal optimist is typically reared in a family that preached and practised all is for the best, in the best of all possible worlds. Failures are taken lightly, there is no appreciation of the consequences of poor performance. This can cost the investor substantially, as typically an optimist will deny or rationalise losses.

In both cases investors will ignore fundamentals when they are not in agreement with the investors' feelings.

Money and Relationships

Marriages often fracture around money as finances become a battlefield in which partners blame their personal pain on the other,

rather than seeing its source within themselves.

Remarkably we think about money more than sex. Money is part of our relationship with ourselves in terms of identity and value, and with others in terms of family, love and friendship. Money is the crucial link between our interior lives and our exterior being. If we have a poor relationship with money it is likely we also have a poor relationship with our inner beings.

Couples who fight about money argue more about how it is to be spent or invested rather than about how much they have: the arguments are really about the values, expectations and personal meanings attached to money. Unfortunately, many couples never figure this out and arguments keep arising over the same issues. There are, of course, many pieces to the puzzle of financial relationships, but there are two extremes. At one end of the spectrum are those who are orientated to the present – they buy what they want now and don't wait for a sale or even evaluate whether a particular purchase is appropriate. They also tend to be fairly conventional in their buying and planning. They are called morphostatic planners. At the other end of the spectrum are morphogenic planners. These people are flexible, wanting as many people as possible involved in the planning or purchasing process, usually considering all the possible consequences involved in a particular decision and taking considerable time to reach a conclusion.

For many couples money is a taboo subject. It's not very romantic to talk about your credit history or what you think about debt. It is not, however, too romantic to find, after the honeymoon period, that your money values are diametrically opposed. In a recent *Press* article Janine Morrell and Jason Gunn, heads of Whitebait TV, discuss their spending preferences. Morrell likes to spend money on furniture, Gunn likes Playstations. Janine tells a story of how she bought two new chairs at a time when things were tight, and hid one in the boot of the car for two weeks.

'Janine says that in times of recession, expand,' Gunn says. 'Which explains the chairs.'

Read the following hints to help head off nasty surprises:

- ☐ Discuss your money style. (If you know what that is!)
- ☐ Plan how you'll merge everyday finances.
- ☐ Consider a pre-nup or a written agreement.

Bear in mind agreements are not set in stone and can be altered as your relationship and goals alter. Here are some topics you should consider working on:

- ☐ Paying down debt and setting aside money for retirement.

- ☐ Each working partner should buy income protection insurance.
- ☐ Keeping records.
- ☐ Making a will.
- ☐ Communicate about your financial future – set your goals and priorities, transform them into dollars and cents.

To kick start your discussions each of you should complete the following quiz and then compare answers:

1 My attitude
 towards
 money is:

- a) money's for ☐
 enjoying
- b) money's for ☐
 security
- c) money's for ☐
 sharing

2 When I
 spend a lot
 of money
 on my
 partner I
 think:

- a) they ☐
 deserve it
- b) they'll love ☐
 me more
- c) they'll ☐
 appreciate
 me more

3 When I
 spend a lot
 of money
 on myself, I
 feel:

- a) guilty ☐
- b) important ☐

c)

pampered

☐

- 4 What's the most amount of money you'd be comfortable spending without checking with your partner?
\$ _____
- 5 How much money is it okay to spend on yourself each month?
\$ _____
- 6 How much money should you save each month?
\$ _____
- 7 Which of you is generally better at managing expenditure and budgeting?

How Financially Compatible Are You?

Arguments about money can be a nightmare – but how can you tell when it's gone too far? Take our quiz and find out ...

- 1 How do you approach the subject of money compared to your partner?

a)

We're both ☐
fairly
similar in
our outlook
– quite
organised
really.

b)

Similarly – ☐
we're both
disorganised,
always
getting
panicky at
the end of

the month,
which
causes rows
and
tension.

- c) Completely different – it's what we argue most about. ☐
- d) We don't talk about it. ☐

2

How often
do you row
about
money?

- a) Once a week, if not more. ☐
- b) Once a month. ☐
- c) Rarely – it's not really a matter for disagreement. ☐
- d) Rarely – we never talk about it. ☐

3

When it
comes to
the
household
budget, ie.,
paying the
bills, who
controls
the purse
strings?

- a) I do – it cuts out the ☐

arguments
and makes
everything
simple.

b)

Both of us,
but we're
not too hot
at staying
on top of
things.

☐

c)

Both of us,
we take
joint
responsibility
so
everything
works
efficiently.

☐

d)

He does.

☐

4

If you
bought a
pair of
expensive
earrings for
yourself on
the spur of
the
moment,
how would
he react
when you
told him?

a)

He'd tell
you how
great you
looked in
them
because
your
budget
allows you

☐

to treat
yourselves
once in a
while.

b)

He'd
lecture you
on being
too
extravagant
and tell
you to be
more
responsible.

☐

c)

Nothing
because
you
wouldn't
tell him – it
would lead
to another
spat.

☐

d)

Nothing,
because
you told
him they
were a
present
from your
mother.

☐

5

When you
go out for a
special
occasion
which of
the
following is
most
likely?

a)

Goes for a
big blow-
out, orders
expensive

☐

b)

items, and
borrows
from you to
cover the
bill, much
to your
fury.

Keeps to a ☐
budget that
you
previously
both
agreed to
for
occasions
like this.

c)

Makes you ☐
go Dutch,
even
though it
was meant
to be his
treat.

d)

Realises ☐
that neither
of you has
any money,
and that
you may
well be
doing the
dishes.

Relationships With Friends and Colleagues

Relationships with friends play a significant role in determining our social perceptions and actions. Most things we do are intended to bring us social benefits. Pressures from our families and social circles can lead to actions that could prove contrary to our achieving successful outcomes.

As children we are educated to compete with friends and siblings, so it is only natural that as adults we continue with this behaviour. The desire to compete is a healthy and most often productive need. It inspires us to achieve things that we might not otherwise accomplish. On the other hand it may make us take chances that should not be

taken, or take actions motivated by the desire to please, to conform to social expectations, to gain approval or even in some cases the desire to be punished.

Consider these statements in relation to your behaviour:

- 1 If you are very competitive, spend some time thinking about precisely why you feel that need – the insights you achieve may help you redirect that competitive energy.
- 2 It is better to anticipate than to respond. Make your own rules rather than play by others.
- 3 Don't put yourself in the position of making or accepting financial recommendations.
- 4 Identify errors in judgement or investments made on the basis of the need to please.
- 5 Decide whose approval is important to you and for what reason. Then you can limit your need for approval.
- 6 Replace any negative interactions with positive experiences.
- 7 Most importantly, keep financial arrangements and friendships separate.

Human relationships are extremely complex, we do things for many reasons and cannot always explain why we have acted in a certain way.

Now, we not only hear investment talk from our friends, television programmes and channels are dedicated solely to financial news, as are magazines and newspapers. The more we talk about investment, the more we do it.

Conversation allows for the rapid exchange of information, opinions and emotions. This is important for investments; imagine what is happening in the financial world as you are reading this, somewhere in the world brokers are talking with clients and other brokers, analysts are communicating with executives and managers, individuals like you are talking with family friends and colleagues, and several taxi drivers are giving their passengers financial tips. Time to get out of the market?

In fact, a recent study of high income investors found that more than half the shares they bought were after their interest was aroused by someone else. Furthermore, after the investment was made they talked on average to 20 other people.

Social people who share knowledge and ideas, therefore, are more likely to learn about investing than non-social people, with highly social people more likely to invest in shares or superannuation plans. When researchers studied the relationship between socially active households and sharemarket investment, they found that the social

interaction was magnified when people were in the 'right' environment – that of fellow investors.

Investing humour - 10 reasons why investing is like having sex

Do you enjoy David Letterman's top 10 list? Well, here is an investing-oriented Letterman-like list from Dustin Woodard, website Connoisseur.com

- 10 Some like it long, some like it short.
- 9 You can study the market as much as you like, but it all comes down to luck.
- 8 Those who talk about it the most, have the least experience.
- 7 One simple mistake could lead to 18 unprofitable years.
- 6 Some prefer to sit back and watch it grow.
- 5 Terms include swing trading, asset turnover, naked call, after hours, insider trading, silent partner, blind entries, 30-day wash rule, straddle, triangles, descending tops, ascending bottoms, pump and dump, partial surrender, stop order, position limit, voluntary liquidation, and explicit interest.
- 4 Low confidence can keep you out of the market.
- 3 Everyone tends to focus on performance.
- 2 Some do it alone, others do it with a group, and some hire professionals.

And the number one reason ...

- 1 Some positions are better than others and the best position is always up for debate!

And remember, past performance is not necessarily indicative of future results!

There is an old saying: birds of a feather flock together, and that holds true with your own social group. Yes, gentle reader, your social group affects your wealth. If you think about it you will realise your peers have similar tastes, goals and lifestyles. Investment beliefs are part of our social exchanges. If your peer group does not value investing, the conversation will rarely (if ever) turn towards investment topics. A different group might discuss investments frequently.

The notion that we tend to conform to the behaviour of others is among the most accepted principles of psychology. Your life is full of instances, large and small, in which the social norms of your peers, or community, influence your individual decisions. Have you ever seen a film because a friend gave you a good report? Or bought a bestseller because it was a bestseller? Sure you have. Mostly such conformity is a good thing and it's one reason society functions – if people didn't accept norms, we would not be able to drive a car without fear of a head-on collision, let alone establish a system of law and government in which people by and large follow a specific ideology (say democracy) and obey its rules.

The problem arises, however, when people conform to larger habits

or trends that may go against their own interests. In financial terms, that means allowing the judgement of others to steer you into unwise investments or out of sound ones. It's a complicated issue because typically the opinions of others – a friend, a financial advisor, a loved one or the general public – should count for something. That is why understanding when to go along for the ride and when to buck the trend and make your own rational and well-researched decisions can have a sizeable effect on your wealth creation programme.

Consider this: Fact 1, from 1984 – 1995 the average equity linked managed fund posted an average annual return of 12.3 per cent, while the average bond fund returned 9.7 per cent. Fact 2, from 1984 – 1995 the average *investor* in an equity linked fund earned 6.3 per cent, while the average *investor* in a bond fund earned 8 per cent. What is wrong with this picture? How can funds earn more than those who invest in them? Because, rather than investing in a few well-researched funds and holding them over the long term, investors tend to flit in and out of funds in an effort to maximise their returns.

Moving in and out of funds would not matter if investors switched into funds that outperformed those they have exited. The problem is that they don't, and much of the reason can be attributed to the folly of following the herd.

HERDING

As you learn other investors' opinions and social consensus forms, a herd begins to form. Imagine a herd of antelopes gathered together in a group for protection against predators. One minute the herd are doing nothing and the next they are in full flight. Each antelope always has its eyes and ears open so that it knows what the other antelopes are doing, it doesn't want to be left behind.

As an investor you pride yourself on keeping up with what other investors are doing; talking with advisors and peers, watching the business news on television, reading the business pages, viewing your favourite websites or closely follow chatroom postings. The problem with following the herd is that it magnifies the psychological biases. Investors make decisions based on the feel of the herd rather than rigorous analysis. In addition, the feeling of regret on picking a loser is lower when you know others have had the same experience. Misery loves company.

A classic example of investors forming a herd and affecting the overall market is best illustrated by the irrational exuberance investors displayed in the late 1990s for internet companies. Analysts were so puzzled by the extremely high valuations that they concluded that new valued measures were needed for this economic revolution. These are the types of comments that are often uttered during a period of

extreme herding because the high process cannot be justified with traditional measures. When the scales say you have gained 12 kilograms, is the obvious problem that the scales no longer work? For example, at that time Yahoo's P/E (Price Equity Ratio) was 1300 and eBay's P/E was 3300. This effectively means that the earning period to justify investing in these companies was 1300 years and 3300 years respectively. As I write this Google's P/E is 66.94 – which means it will take over 66 years at current prices and profits for investors to recoup their money.

INVESTMENT CLUBS

One aspect of consciously selected herding and selection socialisation is that of investment clubs. Currently there are a few in New Zealand but the behaviour they evince parallels that of individual investors. An investment club is usually a group of friends, family members or co-workers who have bonded together to pool their money and invest in the sharemarket. Frequently the clubs are all men or all women. Typically, they meet once a month to discuss investments, contributing a nominal amount to the kitty.

The purpose of clubs is generally good: to create an environment for learning about investing and achieving good returns. Most clubs also serve a social purpose, the meetings provide an excuse for family and friends to get together. Members enjoy the idea of sharing research skills and knowledge about markets while socialising on a regular basis.

The social dynamics of the clubs play an important role in their investment success. Although some invest as a pretence to socialise, others take their investing seriously. One club, the Klondike Investment Club of Buffalo, Wyoming, was rated as the number one club in America. There were 18 club members, some young, some old, some blue collar workers and some white collar workers, some with advanced degrees and some business owners.

I know you want to know the secret of their success. They exhibit a high degree of investment formality. For example, the club requires all investment decisions to be made with the help of a vigorous report produced by the sponsoring member. They rely on research, not just stories about a firm. This is important because it helps the club members avoid at least some psychological biases. Decisions are based on reason and logic rather than emotion.

Another club has quite a different goal with socialisation as their primary objective. This group of retired friends have a Christmas Party and a day long golf outing, and other events planned in much detail. Decisions on investments are frequently made without much analysis, the discussion concentrating on hot tips and speculations. Thus, the

club frequently buys at the top and sells at the bottom. The informality allows each member's psychological biases to combine with the others and be magnified.

THE MEDIA

One of the factors driving our psychological bias is the media business; investment writers want to keep us interested by telling a good story, otherwise we will cancel our subscription to their magazines or papers, or change the channel. Because of this, reporters search for the best sound bite to catch our attention. Sound bites, however, don't convey any serious investment analysis.

This is disappointing as many of the experts quoted have access to research departments and tremendous analytical tools. Surely, we assume, their opinions are based on significant analysis. The media's penchant for story telling naturally makes us gravitate toward active investment decisions, appealing to our interests and emotions. In this way we tend to overreact to both good and bad news, causing the prices of favoured companies to rise too high and the prices of tainted companies to fall too low.

And then there is investment porn. You know the stories: The top 10 funds to buy now, how to double your money, personality profiles that read like fan magazines, pieces that praise any path to profits. Investment porn titillates and excites, but succumb to it and it could be hazardous to your financial health. Hot tips from market experts on TV and in financial magazines are infomercials thinly disguised. Ignore any headline with the words 'hot', 'safe', 'today' or 'now', or any variation thereof. Porn will keep coming as long as we keep reading it.

In fact, investors should follow the old adage, no news is good news. You should pay less attention to financial news, print and the internet, investors who tune in too closely to financial reports fare worse than those who tune the news out. By the time information reaches our attention, acting on it is too late. Researchers surveyed two groups of investors, one who had no news and one group who received a consistent stream of information, good and bad. Those investors who had the information and were trading earned only half as much money as those whose trades were not influenced by the media.

In the case of investment portfolios speed is not of the essence. In investing media reports suggest that the slow die first. We are told that you need the fastest broadband provider, the most up to date online information, and to trade on the fastest online system. But bear in mind, making split-second decisions based on news reports is not investing, it is trading. Trading is like gambling in that it fosters

strong emotional responses. The need for speed magnifies psychological biases. Instead of buying a stock because you think the company's products, market share, and management will dominate the future, you buy because you think the price will rise in the next week, day or hour. The firm's performance and likely growth becomes ancillary or even irrelevant.

Do you do this?

You may be prone to follow the herd if:

- You make investment decisions frequently.
- You invest in hot stocks or other popular investments.
- You sell investments because they are suddenly out of favour, not because your opinion of them has changed.
- You are likely to buy when stock prices are rising and sell when they are falling.
- You make spending and investment decisions based on the opinions of friends and colleagues.
- Your spending decisions are heavily influenced by those products, restaurants or vacation spots that are 'in'.

Emotions and Investment Decisions

'I must say I hate money,
but it's the lack of it I hate
most.'

- Katherine Mansfield

EMOTIONS

Happiness is electrical activity in the left front part of the brain, it comes from getting married, having children, having friends, getting rich. The study of happiness is still new, more papers are written about our negative emotions, such as getting sad, worried or angry. For every 100 papers dealing with anxiety or depression, only one will deal with a positive trait.

The Difference Between Men and Women

Men often complain about their wives' volatility. Research now confirms that women really are both happier and sadder. Positive and negative emotions are not polar opposites, you can have both in your life. Women experience more of all emotions except anger. First it was found that women experience twice as much depression as men. Next, researchers found that women report more positive emotions than men, more frequently and more intensely. It all points to men and women having a different emotional make-up. Cognitive psychologists say that men and women have different skills related to sending and receiving emotion. Women are expressive; men conceal or control their emotions. Women convey emotion through facial expression and communication; men express emotion through aggressive or distracted behaviour. Does the difference lie in biology, social roles or just women's willingness to report emotion? That's up for debate.

Psychologists and economists examining the role of emotions in financial decisions have found that feelings and emotions can affect decisions. These can be due to factors totally unrelated to the decision at hand; the sun is shining or the Silver Ferns have won. When we are happy, we are more likely to make positive decisions. In my experience investors (and their advisors) grossly underestimate the influence emotions, moods or feelings have on the investment process.

Having said that, however, researchers have found that lack of emotion destroys the ability to make rational decisions. They reported on patients who had suffered brain damage where their ability to feel was impaired but the centres that controlled intelligence, memory and logic were intact. These people were socially dysfunctional and were unable to interact in a normal social manner (refer back to Chapter Seven and the importance of social interaction in the investment process).

Let's go back to our evolutionary past. Homo sapiens evolved during the Pleistocene era (18 million to 10,000 years ago) a time of hardship and turmoil. We endured long freezes as glaciers formed and then ferocious floods as the ice melted. Our companions were terrifying creatures such as mammoths, elephant-sized ground sloths and sabre-toothed cats.

By the end of the Pleistocene era all those animals were extinct. Humans on the other hand had evolved: our brains were larger and we used our intelligence to make fire and sophisticated tools, we developed speech and social rituals. The way humans evolved over this period created what the scientists call a 'catastrophic brain'. The way our brain works is by looking for what is wrong. The problem being, it worked in the Pleistocene era, but it doesn't work in the modern world. Negative thinking, therefore, is deeply ingrained in the human psyche. Experiments have shown that we remember failures or negative experiences more vividly, than successes or positive experiences. We dwell on what went badly, not on what went well. Consider this: Of the six universal emotions, four are negative, anger, fear, disgust and sadness; one positive, joy; and surprise, the sixth, is neutral.

The ability to feel negative emotions derives from an ancient danger recognition system formed early in the brain's evolution. The prefrontal cortex that registers happiness is the part used for higher thinking, an area that evolved later in human history. In essence, what our biology tells us is that negative emotions are fundamental to the human condition.

So how does this relate to financial decisions? Financial decisions are complex and include risk and uncertainty, our brains have evolved to weigh the negative aspects more strongly than the positive, thus influencing the outcome. We are, therefore, less likely to invest in assets perceived to be risky, such as shares. If we are in a good mood, however, that emotion will make us more likely to be optimistic in evaluating an investment.

FEELINGS AND FINANCE

Traditional financial theory expects each investor to make rational

decisions using tools such as fundamental analysis and modern portfolio theory. These tools require assumptions about the future. What growth rate will the firm or fund achieve over the next three years? What are its expected return or expected correlation with other assets? As investors we are meant to resolve these uncertainties in an unbiased, unemotional way. If you feel unable to do that or haven't in the past, don't despair – even sophisticated, experienced investors can't agree about which methods produce the most accurate assumptions. And, as we have seen, the experts can display the same biases as mere mortals like us. Even those investors who use quantitative methods, such as fundamental analysis, must include educated guess work about some assumptions – some analytical techniques are more sophisticated than others, but they all involve assumptions about the future. Consider, for example, the constant discount rate model taught to finance students around the world, $PV = D_1 / (K-g)$. Investors must estimate the constant growth rate 'g'. Given the influence of mood on risky and uncertain decisions the expected value of the growth rate may become biased. In turn, this biases the value computed in the model.

An investor who is in a good mood might optimistically overestimate the growth rate to be 7 per cent. This would cause the investor to think the share is worth 2 per cent more than the belief of an unbiased investor.

LIVING WITH THE CONSEQUENCES OF DECISIONS

A Cautionary Tale ... Or Two

By now you will be fully aware of the biases afflicting investors. In my experience, the best way to observe character flaws is to study others; their mistakes are so obvious. Like Mary Poppins, you and I will be practically perfect.

A gentleman who was fixed in the financial world as practically perfect was Nicholas Leeson.

In 1995 Mr Leeson became famous for having caused the collapse of his employer, a 232-year-old bank, Barings PLC. How, you ask? In 1992 Leeson began to engage in rogue trading in order to hide his subordinate's trading errors, or so he said. Eventually, he incurred losses of his own to the value of \$1.4 billion. He stated that he 'gambled on the stockmarket to reverse his mistakes and save the bank'.

Why do you think he did this? The following rationales occur to me:

- 1 He wanted to avoid regret at admitting he had made losses and did not want to expose himself to the ridicule of his peers.

- 2 Remember the house money effect? He was, he stated, gambling.
- 3 He was overconfident.
- 4 He was trying to break even.
- 5 He was loss averse and the sunk cost fallacy led him to throw good money after bad.

Mr Leeson obviously was not being honest with himself.

Now let us turn to a couple who invested in that perennial favourite of New Zealanders, real estate investment.

Bill and his wife Hillary were very excited to greet the arrival of their first child while in their early 30s. Like good parents everywhere they turned their attention to providing for their child's future. They are a highly educated, intelligent couple who were aware that once inflation and tax were taken into account even returns that look attractive can be substantially reduced.

Bill and Hillary were good friends with James. James had, over the years, displayed a great facility for finding undeveloped property, cleaning it up, dividing it into sections and selling it at a substantial profit. James had been reselling these sections at between one and two times what he paid for them. In addition, he was using borrowed money, and was able to claim substantial tax deductions.

Prior to this James had had personal problems and Bill had supported him during this difficult period, so James felt an obligation to repay that kindness. Hence, James asked Bill to take a share in a small development which they had sold for 75 per cent more than their initial investment. One evening when Bill and Hillary bumped into James he mentioned another deal – a development company had just gone bankrupt and was eager to sell a rural property with great potential on the shore of a lovely lake.

It was agreed they would both go in as equal partners with James reselling the sections for around \$460,000. Bill and Hillary had \$17,500 in savings, so borrowed the rest.

Exercise 1

On a scale of 1 – 10 how would you rank this as an investment whose purpose is to fund university education in 15 years?

On the scale 10 is extremely suitable and 1 entirely unsuitable.

Bill is now making payments on the \$85,000 loan he took to fund his half of the development. When he sees James a few months later James tells him there is a problem. It appears that the property has never been properly surveyed and that although that process is now underway, it is taking more time than he thought. No sections can be

sold until the process is complete. At this point the original loan of \$85,000 is due for the renewals, the bank, however, only wants to renew for \$75,000, so Bill will have to find the extra \$10,000 himself. Bill and Hillary have saved another \$10,000 in the intervening months so they put that into the project. James is embarrassed but still enthusiastic about the development.

Exercise 2

- 1 Put yourself in this situation – if you were Bill or Hillary, how would you react emotionally? Would you be worried, anxious, or patient, believing that investing often meets with glitches?
- 2 Would you begin to feel regret? Specifically, would you feel that anyone should be blamed?
- 3 If so, who would you blame? Yourself, James or the situation?
- 4 Think about the sequence of events. Does it seem obvious to you that Bill and Hillary would strike problems? Could you identify any warning signs?

Try to answer this question on a scale of 1 – 10, where 10 is very obvious and 1 is impossible to predict.

A year passes, James apologizes that it has taken so long to get things moving and says he can work things out so that Bill and Hillary don't have to make payments on the loan – he will handle the financing details and will construct a show home to speed up sales. He thinks he can do this without asking for additional funds.

At their next meeting James shares good and bad news with Bill – the good news is the show home has sold, but the bad news is that further sales have not eventuated. James feels bad and offers to take over Bill's interest in the development, meaning that Bill would pull out of his investment. He would *avoid further loss* but, if the investment becomes profitable he will lose out on the chance to *lower his loss, recover his investment or make a profit*.

Exercise 3

Put yourself back in Bill's shoes. How would you react? You know James is more knowledgeable about real estate than you and he is a good friend, so you don't think he would take advantage. If you let James take over your share you will have lost \$27,500. By staying in you may lose more money, but if sales pick up you might at least recoup your investment. What would you do?

In fact, Bill told James he understood he was trying to help him and he still expected the investment to pay for his child's education.

Exercise 4

Imagine that six years have passed, again James offers to take over Bill and Hillary's share of the investment, this includes full responsibility for Bill's loan repayments. In addition, James informs Bill that he has an offer for \$43,900 for the whole

development, which he has decided to accept. What would you do?

Again, Bill responded by saying that he did not want to pull out and reminded James that he had said the development would pay for his child's education.

What can you learn from this saga? Bill and Hillary suffered from the same emotional responses as did Nicolas Leeson. And what happened to Bill and Hillary? In the final analysis the real estate investment in Whitewater did not prevent Bill and Hillary Clinton from sending their daughter Chelsea to university. Whitewater caused Bill Clinton considerable problems during his tenure as American President – it was eventually investigated by Kenneth Starr and as we know was a critical factor in Clinton's impeachment. Imagine the end result for him if he had simply taken the loss in the early part of his investment period.

BEING HONEST WITH YOURSELF

Now that you have read these cautionary tales, ask yourself the following questions:

- ☐ Do you sabotage yourself with money – frittering money away, charging less for your work than you should or refusing to save for the future?
- ☐ Do you want to give more to society but feel you can't because your financial situation precludes that?
- ☐ Do conversations about money with your partner erupt into fights?
- ☐ If you have had financial losses or setbacks were they devastating, do you feel guilty?
- ☐ Do you feel stupid about investments and money, not knowing how to make financial decisions and are you afraid of selecting an advisor?
- ☐ Would you prefer to avoid bank statements, investment decisions and insurance policies for the rest of your life?
- ☐ Are you always in debt, always struggling to meet your outgoings and still spending too much, digging an even deeper pit of indebtedness?

In the winter months we often say we have SAD: Seasonally Affective Disorder. Sun, or lack of it, affects our moods and how we make decisions. Scientists have been documenting this phenomenon for decades. Sunshine makes us feel good and optimistic about our future prospects, and as a result affects our decision-making process. I realise this may sound bizarre to you, but financial economists have studied seven stockmarkets around the world: Australia, Great Britain, Canada, Germany, New Zealand, Sweden and the US. They found that

market returns were lower in the autumn when daylight decreases until the longest night of the year. The effect is strongest for markets that are furthest from the equator (Sweden and the UK). The same phenomenon affects our markets with documented rises in the spring for markets in the Southern Hemisphere (Australia and New Zealand). Daylight, or the lack of it, affects moods. Another effect driven by emotion is the January effect, the holiday effect, when prices rise.

MARKET BUBBLES

Optimism skews our beliefs and judgements. Optimistic people are a pleasure to be near but what happens when optimism becomes rampant and the market displays irrational exuberance? The French say everything changes, everything stays the same – that adage could also be expressed as whatever changes, people stay the same. Rampant optimism or irrational exuberance lead to market bubbles. Market bubbles are a fusion of millions of investors' emotional responses, mostly greed. Market bubbles are not a recent phenomenon, nor are they uncommon.

The Black Tulip is about one of the most impressive market bubbles that occurred in Holland in the 1630s. And, yes, the commodity so highly sought after was the tulip bulb. Over a five year period tulip mania inflated bulb prices to the point where one bulb was worth 10 times a yoke of oxen, around US\$100,000. Then, the story goes, an out-of-town sailor inadvertently popped the bubble as, mistaking a valuable bulb for an onion, he ate it. Panic erupted (herding behaviour) and within a week the bulbs were almost worthless.

If you think you would be tempted by rampant financial optimism consider a self-binding scheme. The classic tale is that of Ulysses who ordered his men to tie him to the mast of his ship so the Sirens' song did not lure him to his destruction. This clearly illustrates a freely chosen hedge against his weakness of will.

Consider this: Living in a new era ... has ushered in a new type of economy. Those who stick to the old ways will be left behind. Traditional company valuation techniques do not capture the value of this revolution. If you lived in 1850 you would have said the railroad, in the 1920s the radio, in the early 1990s you might have said biotechnology. In each case, this rationalisation accompanied a great bull market and preceded a great decline.

Spot the Bubble

The 1929 market crash and the dot-com bubble in 2000 were very similar. In both cases the market was:

☐ Driven to new highs.

- ☐ Supported by margin trading.
- ☐ Overconfident after a long bull run.
- ☐ Characterised by talk of 'a new era'.

And both bubbles crashed spectacularly eroding shareholder wealth.

Ask yourself this: By what logic could anyone believe that internet companies are worth anything like the ludicrous sums the market has attached to them? Here are the words of Jim Cramer, television pundit and sometime hedge-fund manager. He is quoted by the editor of the *High-Tech Strategist* newsletter as saying:

The only way to catch up is to join the crowd ... they are buying Google because, what the heck, when the market's up, buy Google ... there simply aren't enough trading days left to make a lot of money ... the clock is ticking ... 'Damn it all, I gotta get in'

Media influence anyone? No cool rational thinking here, or any comment on such old-fashioned concepts as value. Foolhardy investors will regret their enthusiasm quickly.

What are Your Emotions Around Money?

One of the facts of human nature is the urge to analyse our characteristics – we love quizzes and hope to be guided by the results. We also read our horoscopes for a peek into the future.

Quiz: Identify Your Emotions Around Money

Do
financial
differences
between
you and
others instil
feelings of
guilt, envy
or sadness?

Yes ☐

No ☐

Do you
hate your
work
situation
(what you
earn is
often

internalised
as a
reflection
of your
value)?

Yes ☐ No ☐

Is your life
marked by
frequent
bouts of
money
anxiety and
money
worry?

Yes ☐ No ☐

Do you find
yourself
closing
your mind
to tax,
budgets,
bills,
mortgages,
insurances?

Yes ☐ No ☐

Of course, there are no right or wrong answers to this – your responses will indicate your attitudes to your financial life, and, like it or not, it is a major part of life.

SOCIALLY RESPONSIBLE INVESTING

Socially Responsible Investing (SRI) is a general term used to describe investments that reflect ethical values, respect for communities, the natural environment and people. Actions which support this include meeting or exceeding local wage rates and benefits, implementing sustainable agriculture standards and animal welfare guidelines. You will be interested to know that the occupational groups that support ethical investment are doctors, health workers, social workers and psychologists: occupations that are dominated by women.

Until 1993 investors avoided companies who supported the South African regime – this disappeared when Nelson Mandela rose to power. These days there are two screens for a socially responsible company: positive for companies that focus on doing good and negative for eliminating companies considered harmful, such as:

- ☐ Alcohol, Tobacco, and Gambling.
- ☐ Products/Services.
- ☐ Weapons.
- ☐ Animal Testing.

Do you do this?

- You don't have a written financial plan.
- You don't seek out a contrary view.
- You have no exit strategy.
- You don't rank probabilities when making your investment decisions.
- You rely on gut feeling or intuition.
- You have no feedback loops to analyse your position or to rebalance your portfolio.
- Do you analyse your likely investments or do you let emotions like greed or fear drive investment decisions?
- You suffer from feelings of blame and resentment – sitting on the sidelines and complaining about your financial life.
- You suffer from feelings of fear and self-doubt – images of failure in making a bad financial decision.
- You are locked into dependency – on the government, your partner or inheritance.
- You believe more money will solve your problems – money does not solve problems, people do.
- You suffer from procrastination and lethargy – making excuses to avoid doing what must be done – whether it is budgeting, investment or paying your bills.

Strategies to Defeat Your Errors

(Self-control and Decision making)

'Our favourite holding period is forever.'

– Warren Buffett

INVESTOR STYLES AND CLASSIFICATION SYSTEMS

Market volatility displays, in vivid detail, the important roles of emotions and psychology in driving share and community prices, and the rise and fall of the internet bubble, the volatility of currencies, and the volatility of gold and oil prices. It was emotion that drove the market after 9/11, and prior and post the Iraqi invasion, demonstrating the power of anxiety and uncertainty in driving prices.

Trying to analyse the variety of personal styles has spawned a whole new profession. It is clear, however, that different personality traits are better suited to assessing and pursuing rewards in different environments. Depressive people are better at analysing details and thinking through problems slowly and deliberately. Neurotic people have trouble making decisions and dealing with ambivalence and may trade in sideways markets. Extroverted people feel more positive and move more decisively in search of potential rewards. In general, extroverts are more likely to jump at potential opportunities without gathering background information (such as buying internet stocks during the bubble). Researchers have found that whether we pay too much attention to potential gains, potential losses or have a balanced view of both is determined by our biological hardware.

Investor personality testing is now big business. Personality traits determine how one responds to risky situations, new opportunities and gains and losses. The potential for bad financial decisions can be diagnosed and corrected.

Human nature is funny. When we see a 'Wet Paint' sign, many of us are tempted to touch, very lightly, just to see whether the paint is really wet. When we drive past accidents, it can be hard not to look. When we flip through a magazine or click onto a web page and see a

quiz, we sometimes can't help but do the quiz. One type of popular quiz is the personality test. Life can be confounding, after all – if we can find out more about ourselves, perhaps we can make more sense of our wacky world.

The same is true in the world of investing. It can be instructive – or at the very least, entertaining – to figure out what kind of investor we are. In my investing travels, I've run across lots of categorisations of investors. Permit me to share some with you, and perhaps you'll learn a little about yourself.

- ☐ The perfectionist worries too much about possible future scenarios and is afflicted with decision paralysis.
- ☐ The super-confident investor likes speculation, is responsive to peer pressure and is an easy sale for brokers.
- ☐ The gambler loves playing the market, takes big risks and continues to do so in search of a good return.
- ☐ The trustafarian feels guilty about her unearned money.
- ☐ The fool rushes in where angels fear to tread, makes impulsive decisions and racks up losses.
- ☐ The safety-first investor loses the chance of a good return because of risk.

These investors can all be helped simply by the development of an investment philosophy, and the writing of a financial plan with an exit strategy.

Another way to ascertain your investor type is to think about the style of investing you might prefer:

- ☐ Are you a value investor? Value investors focus on the fundamentals of companies such as cash flow and likely earnings. They like to buy shares which are undervalued by the market.
- ☐ Are you a growth investor? Growth investors look for companies which exhibit signs of rapid growth.
- ☐ Are you an income-earning investor? This sort of investor focuses on the likely income returns from debentures or shares with high dividend yields.
- ☐ Are you a blue-chip investor? Blue chips are large, well-established companies, often considered to be the cornerstone of a portfolio.
- ☐ Are you a small company investor? This type of investor likes small, young firms. They may be risky but they can offer the possibility of a good return.
- ☐ Are you a managed fund investor? This investor allows professional money managers to invest on their behalf.

These styles are not mutually exclusive. Your investing approach may

be to invest directly into your home market and use a fund manager for offshore investments.

If this sounds too complex for you, tick the following boxes as they apply to you.

Obsessive-Compulsive

- ☐ Neat freak; squeezes toothpaste tube from bottom. ☐
- ☐ Has difficulty spending money. ☐
- ☐ When stock falls in price, vows to sell only when it returns to purchase value. ☐

Hysterical

- ☐ Dresses flamboyantly; cries easily at movies. ☐
- ☐ More likely to spend an inheritance on a vacation than an investment. ☐
- ☐ Finds investing boring. ☐

Depressive

- ☐ Has trouble sleeping; loses interest in things. ☐
- ☐ Prefers T-bonds to stocks when investing. ☐
- ☐ Expects to lose invested money often. ☐

Narcissistic

- ☐ Thinks everything is about them. ☐
- ☐ Likes prestige cars. ☐
- ☐ Invests in 'high-flier' companies and enjoys telling others about the successes. ☐

Remedy? The Smart Investor

- ☐ Has a healthy sense of reality; most likely to watch a television show right through rather than channel-surf incessantly. ☐
- ☐ Is wary of getting too fancy in investing. ☐
- ☐ Buys managed funds, blue-chip companies or businesses after a rational analysis; doesn't unload or lose sleep during market dips. ☐

To help you focus on ways to improve your handling of investment, complete the following self-assessment. Remember this is a guide only, not a definite analysis.

For each of the items below, circle the number on the scale, between 1 and 3, closest to your feeling. If you feel the question doesn't apply to you, or the answer is 'No', circle 0.

Financial Self-assessment

Part 1 – Circle the number that most closely applies to you.

		'No' or doesn't apply	Slightly	Quite a bit	Very much
1	Do you plan?	0	1	2	3
2	Do you work hard?	0	1	2	3
3	Do you like maths?	0	1	2	3
4	Do you want to be rich?	0	1	2	3
5	Do you sometimes feel lucky?	0	1	2	3
6	Are you decisive?	0	1	2	3
7	Do you hoard	0	1	2	3

8	things? Do you commit fully to your goals?	0	1	2	3
9	Are you friendly?	0	1	2	3
10	Are you impulsive?	0	1	2	3
11	Are you factual?	0	1	2	3
12	Do you handle your finances well?	0	1	2	3
13	Are you a control freak?	0	1	2	3
14	Do you ever get twitchy when worried?	0	1	2	3
15	Do you like the latest toys?	0	1	2	3
16	Do you tend to believe what people say?	0	1	2	3
17	Are you patient?	0	1	2	3
18	Do you use computers regularly?	0	1	2	3
19	Do you ever take risks?	0	1	2	3

20	Do you have mechanical aptitude?	0	1	2	3
21	Are you hard to influence?	0	1	2	3
22	Do you prefer reading to socialising?	0	1	2	3
23	Do you prefer short rapid tasks over longer ones?	0	1	2	3
24	Are you irritated by people who talk a lot but do little?	0	1	2	3
25	Are you a family person?	0	1	2	3
26	Do you like to bet?	0	1	2	3
27	Do you run out of time to do things?	0	1	2	3
28	Do you finish things you've started?	0	1	2	3
29	Are you forgetful?	0	1	2	3
30	Do you have a	0	1	2	3

good
income?

To the right are boxes outlining each investment style. These are: Careful, Passionate, Factual, Active, Careless, Educated. Fill in your answers below the question numbers. Your total score can then be worked out for each category by adding up your responses. The highest score reflects your strongest category, followed by the others in descending order of influence. You will then have a picture of how you respond to investment decisions; and where, if at all, you need to make changes.

Careful

Question number.	4	7	12	13	17	21	24	28	Add responses together to =
Response.									

Passionate

Question number.	5	9	10	14	16	19	22	25	Add responses together to =
Response.									

Factual

Question number.	1	3	6	11	15	20	22	24	Add responses together to =
Response.									

Active

Question number.	6	9	11	14	19	23	26	27	Add responses together to =
Response.									

Careless

Question number.	2	9	16	19	25	27	29	30	Add responses together to =
Response.									

[illegible]

Factoring in Risk

Part 2 Circle the number that most closely agrees with your attitude to risk.

	Highly disagree	Slightly disagree	Makes no difference	Slightly agree	Highly agree
1 I am not preoccupied with being wealthy. Any financial loss would not keep me awake at night.	1	2	3	4	5
2 I prefer a single risky investment with the likelihood of a greater return to a diversified fund.	1	2	3	4	5
3 Market volatility doesn't worry me.	1	2	3	4	5
4 I am happy to take the time to manage my funds.	1	2	3	4	5
5 I like the excitement of investing.	1	2	3	4	5
6 Price volatility doesn't bother me.	1	2	3	4	5
7 I want capital gain rather than income.	1	2	3	4	5
8 I don't care if my investments are not liquid.	1	2	3	4	5
9 I prefer aggressive investment strategies in specialist areas rather than blue chips.	1	2	3	4	5
10 I don't need to review my portfolio frequently.	1	2	3	4	5

Your Profile

Place your characteristics and scores in descending order, the highest at the top.

Characteristics	Score	Risk level

Scores

1 Below 25: You have a low tolerance to risk and would be best to

- invest with minimal risk.
- 2 25–40: A medium level of risk would suit you best.
- 3 Above 40: You have a high level of risk tolerance and can take an aggressive approach.

The next step is to meld the results of these quizzes. Generally you will find that if, for example, you are classified as a careful investor, your risk score will be under 25. Alternatively a passionate investor would have a risk score in the high 30s or above 40.

Examine the traits you have identified and consider where you may need to make some behavioural changes.

Now that you have some idea of your financial personality traits, let's consider self-control. Most people want to maintain self-control and implement decisions that will benefit them and their family in the long term. As you are no doubt aware, the spirit is often willing but the flesh is weak. There are many techniques, courses and books to help with these sorts of issues, so let's look at two aspects that will help you achieve some behavioural control: controlling yourself and controlling your environment.

CONTROLLING YOURSELF

First, create rules calmly and rationally at a time when you are not feeling emotional. Consider these common rules:

- ☐ People control spending by cutting up credit cards.
- ☐ Alcoholics don't have that first drink.
- ☐ Retired people don't spend capital – only income.
- ☐ People with superannuation funds don't access them until retirement.
- ☐ Investors try to maintain a long-term perspective during bear markets and don't sell.

Another simple method is to control your environment, for example:

- ☐ People on diets don't keep the wrong food in the house.
- ☐ Investors who trade too much cancel their internet and magazine subscriptions.
- ☐ Gamblers don't go to casinos.
- ☐ Long-term investors don't examine their portfolios daily or weekly, or even monthly.
- ☐ People who have trouble getting out of bed place the alarm clock across the room.

Ask yourself the following questions:

- ☐ Am I disorganised?

- ☐ Are all my financial and legal documents accessible and together, or are they scattered around the house?
- ☐ Do I lose records?
- ☐ Do I have a good grasp of my long-, medium- and short-term financial plan – and is it written down?
- ☐ Do I have a set time when I review my plan?

Let's examine an area where the majority of New Zealanders are failing lamentably – or, if you want to put it another way, making a fabulous job of racking up millions of dollars in credit-card debt.

Funny Money

Americanesia Expressaphobia, n. Gk. Financial application, first diagnosed in the late 20th century, in which the supplier forgets the amount charged on a credit card but is terribly afraid that it's way too much. Clearly related to *Visago, n.*, in which a high level of debt prompts feelings of nausea and dizziness.

In a perfect world we would avoid too much credit-card debt and would never have to deal with the desperation of being unable to meet our credit-card payments, or the frustration of not being able to afford what we really need because every cent has to go towards keeping up our minimum payments. But, it is not a perfect world and unfortunately the distressing situation I have just outlined is the norm for many people.

SAVING AND SELF-CONTROL

If you find yourself with credit-card debt, or headed there, take control of your spending now, don't wait until your situation worsens. Why did you use the cards and keep charging items that weren't necessary even as you were struggling to make the minimum payments? It doesn't matter. Taking control of your spending will empower you in a way that spending never will. Take control of your spending or you may not be able to save for your retirement, or acquire the things you will truly need or at the worst you could face bankruptcy.

The simplest way to get control is to use cash. The problem with cards is that you don't feel like you are using real money – the purchasing process is quite disconnected from the unpleasant or painful feelings when you get the credit-card statement. In fact, studies show that most people are much less likely to spend with cash than with credit cards.

Along with identifying your investment traits and controlling your spending, you need to beat your ingrained psychological biases. By now you have taken the first step – that of understanding the psychological basis we labour under when making financial decisions. Secondly, know why you are investing. Don't have vague goals like 'I want money for my children's education', or 'I want money to travel when I retire'. Some people couch their goals in negative terms, 'I don't want to be poor'.

My clients find it much easier when we quantify goals specifically, defining when their goals are set, and how much money they will require. For example, if their goal is retirement we set a date and an amount. If they require \$55,000 in income, say, they will need a capital amount of \$800,000. Having specific goals helps focus on the 'big picture', which means you can consider the long term when monitoring, measuring progress and determining whether or not your investment behaviour matches your goals.

Have a quantitative set of investment criteria. This will allow you to avoid investing on emotion, rumour, stories and other psychologically based biases. It can also help to write down your investment criteria.

Keep in mind some simple diversification rules; diversify your sharemarket investment by sectors and geographically, consider managing some of your portfolio personally as well as using other managers. Invest in assets that are not correlated, such as shares, government stock and property.

Finally, and importantly, control your investing environment. If you are buying and selling as a trader only, check your shares once a month – in this way behavioural reactions such as snake bite, seeking pride, and playing with the house money will be inhibited. Trade only once a month and on the same day – this will help you avoid the misconception that speed is important, and avoid the trap of overconfidence.

Review your portfolio annually to see how it lines up with your specific goals. When you review your portfolio keep in mind the psychological biases of status quo, endowment, representativeness and familiarity. Does your portfolio structure enhance and contribute to meeting your investment goals and maintaining diversification? Keep records so you can overcome cognitive dissonance and other memory biases. I also suggest to clients that they write down their emotional responses each time they review or alter their portfolio or investments.

Now, for some further principles to consider. Every dollar, no matter its source, spends the same. *Mental accounting* describes the way people treat money differently depending on where it comes

from, where it's kept, or how it's spent. It can be useful when it leads you to treat savings for a home or retirement as sacred. But, it can be dangerous when it causes you to spend money from some sources, such as gifts, bonuses or tax refunds, with less thought than should be given. Conversely, treating some money as too sacred – an inheritance, for example, or even long-term retirement savings – can lead to overly conservative strategies that will leave you exposed to the ravages of inflation or missing the opportunity of profit which could run into substantial sums of money. That is why it is important to view all money equally. That is not to say you shouldn't have 'mad money', but plan for this by putting it in a designated account. If you can't kill the beast, tame it!

One of the bedrock principles of behavioural finance is *loss aversion*. Losses hurt more than gains. The pain we feel from losing \$100 is much greater than the pleasure we feel from gaining \$100. This is why we behave inconsistently when taking risks. For example, we act conservatively to protect gains by selling winners, but recklessly when trying to avoid losses by holding on to losing investments in the hope that they will become profitable. In extreme cases of loss aversion investors sell all their investments during market turmoil. Although (somewhat) comforting in the short term, such efforts don't work in the long run.

One of the most common mistakes we make is the *sunk cost fallacy*. Repeat after me, money that's spent is money that doesn't matter! Financial decisions should not be based on previous investments or expenditures. This tendency is harmful for the simple reason that past mistakes shouldn't lead you to make future mistakes. About the only choice previous outlay should influence is the decision to ask for a refund.

The way you *frame* or code decisions profoundly influences the choices you make. The same set of options might lead to a different decision depending on whether you view your choice as one of selection or one of rejection, or whether you view it as protecting a gain or avoiding a loss. That's why it's wise to view a decision from all sides – not just the pros and cons, but the ways in which a decision might be framed in your mind. This is especially useful for people who suffer from 'decision paralysis'.

Over time investment expenses and price hikes can lead to the difference between financial freedom and just scraping by. All numbers count, even if you don't like to count them.

We all tend to make mountains out of molehills, to quote an old adage. We place too much weight on certain facts, figures and events. *Anchoring* means we fixate on a base rate and can subsequently make deleterious financial decisions. We also tend to place too much

emphasis on especially memorable or unusual events. I would like \$10 for every person who reminds me of the crash of 1987 and uses that as an excuse for their negative opinions of sharemarket investment. A failure to fully grasp the role that chance plays in life leads many investors to be overly impressed with short-term success and other random or unusual occurrences. Remember: *regression to the mean*.

We all view our abilities through tinted glasses and display misplaced confidence. *Overconfidence* is tough to admit – but we don't know everything. Hubris leads investors into all sorts of financial dilemmas. The most common belief is that you can pick investments with better than average success, particularly when we think we have special information or personal experience to make us savvy. In reality there is little reason for even the most sophisticated investor to believe that she can pick shares or manage funds better than the average person on the street.

Confirmation bias makes it hard for us to admit mistakes – even to ourselves. Our patterns of thought lead us to find support for even the most questionable ideas. Subsequently, our ability to make sound decisions is weakened because we don't evaluate relevant information rationally. Try tempering your self-confidence by sharing your financial decisions with others, seeking a critique of your decision-making process.

You are not a lemming, the trend may not be your friend. *Herd investing* is one example of the tendency to base decisions on the actions of others. John Kenneth Galbraith, a highly respected economist, says we only follow 'conventional wisdom' because it is too hard to think for ourselves. Following the vagaries of crowd behaviour frequently lead to costly overreactions and missed opportunities. That is why the most successful investors and spenders are those who view trends and fads with scepticism and caution.

Another common saying is that knowledge is power. But too much *illusory* knowledge can be destructive. A little knowledge can be a dangerous thing. Studies have shown that investors who tune out the majority of financial news fare better than those who subject themselves to an endless stream of information, much of it meaningless. Similarly the less frequently you check on your investments, the less likely you'll be to react emotionally to the natural ups and downs of the markets.

Forming Portfolios

'Before beginning, plan
carefully.'

– Marcus T. Cicero

MODERN PORTFOLIO THEORY

One of the most common requests I get goes something like this:

Dear Sheryl

In order to meet my financial needs, I need some investment ideas that will produce a long-term yield of 10–12 per cent. What would you suggest?

Sincerely

Ihavunreal X Pectations.

PS: I prefer to take very little risk.

PPS: I don't want to pay any fees or commissions.

Ah, I love the easy ones. As you might suspect, my response to this question, whatever the permutation, is always the same: basically a polite version of 'holy moly, please tell me you have a plan B!' The truth is a 10 per cent return is elusive in its own right, and that is putting it mildly. But worse still, it's impossible to achieve without swallowing a big dose of risk and doing some long-term planning and having a little patience (reading and absorbing the previous chapters will help). This sort of magical thinking is better suited to lotto fantasies.

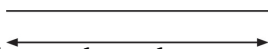
Modern portfolio theory is a good place to start examining what we should be doing. The concept was created 50 years ago by Henry Markowitz who taught us to view our investments as one whole portfolio. He hypothesised that an investor should structure a portfolio in such a way so that she could obtain the highest returns for the level of risk she was comfortable with. Combining investments in such a fashion requires investors to think in terms of diversification. I find that while investors claim to understand this concept, they rarely practise it and implement 'diversification' somewhat differently to the methods proposed by Markowitz.

To implement portfolio theory you must consider three important characteristics of each potential investment. The first two parameters are the expected return and the level of risk (the measurement being the standard deviation of the investments). Measuring risk and return makes intuitive sense to investors. The third important characteristic is the correlation between the returns of each investment. Correlation is how each investment interacts with the others.

MENTAL ACCOUNTING AND PORTFOLIOS

In theory this works very well, but the most difficult barrier to overcome is that of mental accounting. Typically investors place each investment in a separate mental account. One outcome of this is that you discount the interaction between mental accounts that affect the construction of your portfolio. Consider the volatility of the share market. That asset class experiences losses and gains on a daily basis. Modern portfolio theory structures your investments so that the combination of different investments reduces this volatility. In practice, though, investors tend to make buy decisions by individually picking investments as if they were selecting dishes from a menu: 'This looks interesting', 'I think I'll have some of that', 'Maybe a little of this one', 'I've heard that's good'.

Now, I want to convince you again of the validity of a particular mental approach. Consider these lines:



You will actually need a ruler to establish that both lines are of even length; merely knowing these lines are the same does not help you to see them as such. This simple exercise demonstrates that intuition is not all you need, and it must be supplemented or replaced by more critical or analytical thinking – the equivalent of using a ruler to avoid a visual illusion.

Viewing each investment as a separate mental account causes investors to misperceive risks. Investors evaluate each potential investment as if it were the only investment they will own. I find most investors already have a portfolio of some sort when they come to me and are considering adding other investments. Therefore, the most important consideration is how the expected risk and return of the portfolio will change when we add a new investment. In other words, it is how the new investment interacts with the existing portfolio that matters. Unfortunately, I frequently find that investors don't actually want to discuss or disclose existing holdings. It is not uncommon to hear, 'Oh I didn't think that was relevant', and 'I don't want to discuss that, I am perfectly happy with that' and so on. Financial decisions are made in situations of high complexity and uncertainty. In order to

preclude unsatisfactory outcomes it is important to do as much analysis as possible.

So how then do investors build portfolios? Most investors diversify using the pyramid concept. Each layer in the pyramid represents assets allocated to meet a certain goal.

PERCEPTIONS OF RISK

We have separate mental accounts for each investment goal and are willing to take different levels of risk for each goal. We select an investment for each mental account by finding assets that match the expected risk and return of that mental account.



First, investors have a goal of safety. Therefore, they allocate enough assets in the safest layer, the bottom level, to accommodate that goal. Then mental accounts with higher levels of expected risk and return tolerance could be in another layer. Then the investor may allocate another layer for growth. It is the number of mental accounts requiring safety that determine the amount of money placed in 'safe' investments. In contrast, some mental accounts will include the get-rich assets higher up the pyramid. The result of this is that the investor ends up with a variety of mini portfolios.

Diversification comes from goal diversification rather than from a purposeful asset diversification. Ultimately this means that most investors do not have efficient portfolios and consequently are taking either too much risk or too little risk for the return.

One troubling aspect of this behaviour can be seen in retirement portfolios. For most of us retirement portfolios are long-term, yet the vast majority of funds offered and selected have 'naïve' diversification.

Many investors and their advisors distribute money evenly across all the options available to them, such as balanced funds. In practice, this means that the investor may take too little risk or not enough risk to meet their goals.

Since the first days of recorded history the urge or need to speculate has been a driving factor in the development of humankind. Although the cultural growth and technical advancement of civilisations have liberated us from the wider forms of risk-taking, many of us are risk-takers at heart, although we may not be willing to admit to it. Risk is an inherent aspect of life. We live in a world of constant change, instability, aggression and uncertainty. To drive a car, fly or even cross the road is a risk; consider the menace of an inattentive or drunk driver, or terrorists in planes, or when you check

into a hospital where the statistics show you have a considerable risk of infection, death, misdiagnosis or mistreatment. But all of us take financial risks in a way that could jeopardise our financial health.

Despite the confidence that comes from setting long-term goals, investors still view their retirement goals as short-term. Investors who own 'risky' assets must commit themselves psychologically to stay with their investments. One expression of this commitment is the frequency with which the investor monitors the investment and checks its progress. Bear in mind that even during the doldrums in the 1970s the average return from shares was still around five per cent. And from 31 Dec, 1970 to 31 Dec, 2006 the pre-tax return on shares in New Zealand dollars has been 12.6 per cent compared to inflation at 7.5 per cent.

Some nervous investors check frequently and others are less concerned with short-term fluctuations. Take this test to see if you are a short- or long-term investor:

- ☐ Do you take a long-term view?
- ☐ Do you talk long-term and act short-term? (Pay more attention to what you have done in the past than to what you say you will do in the future.)
- ☐ Do you recognise that you will probably find it difficult to stay the course and to live with a long-term commitment?
- ☐ Do you let statements or the media reinforce short-term thinking? (Think of the lifetime of your investment.)
- ☐ Do you have a set of procedures (or better still a financial plan) to follow in the event that you are tempted to make portfolio alterations on a hunch or as a knee-jerk reaction to recent events?
- ☐ Can you live with the consequences if your decisions don't turn out well?

Remember loss aversion? My guess is that selling too soon or not selling, or withdrawing from a managed fund only to watch the values soar, will happen to you at some time in your financial life.

Living with the consequences of decisions is difficult. Investment decisions have both emotional and financial consequences over time. There is potential for worry and for pride, for elation and regret and sometimes for guilt. A financially optimal decision (the one a rational investor would make) is of little use to an investor who cannot live comfortably with uncertainty. And the optimal decision is certainly irrelevant if it is one that means the investor is likely to change course at the wrong time. No one likes to lose, but regret makes losing hurt more. Clearly, the losing investor who believes she should have anticipated the poor performance feels worse than if she believes the

failure could not have been predicted.

Those prone to regret are also likely to blame their financial advisors for what they perceive as mistakes. The combination of hindsight, bias and regret create a powerful toxin. With the benefit of hindsight all things are obvious, so why did the advisor fail to give good advice? (And yes, if you are curious, it has happened to me!)

Objective factors such as time horizon and liquidity needs should receive greater weight as opposed to emotional factors such as risk-aversion, irrational fear of asset classes, propensity for regret.

THE ROLE OF ADVISORS

There are many investors who refuse to admit they are not successful. They continue to take losses, or substantially reduced profits and will not use professional advisors. We are great do-it-yourselfers. The difference between most investors and their advisors or managers is that the professionals are more organised, concise and objective. More often than not an advisor will do a better job than the average investor. Certainly there are advisors and managers who do a lousy job. That is why the decision to employ an advisor is a very important one. You need to know the person who is managing your money, and you should not be a backseat driver. Frequently I find investors do not want to accept the responsibility and effort that comes with investment planning but are constantly second guessing the portfolio planning, which is very frustrating. There are, therefore, several questions you should ask yourself before you decide to go to a financial planner:

- 1 Am I capable of emotionally accepting the fact that someone else is handling my investments? Will I be grief-stricken if there are losses? Will I be happy if there is a profit? Or will I think I could have done better?
- 2 Can I give the planner the 'breathing room' necessary to do the job?
- 3 Am I satisfied that I cannot do the job on my own?
- 4 Will my stress and tension in relation to my finances be relieved by having another emergency fund?

Can Financial Self-Improvement Courses Help?

The simple answer is: yes. They can be of immense value if you are serious about what is being taught. There are many people who tour the country giving financial seminars; however, only a few are worthwhile. Here are some tips on how to get the best value from these courses:

- 1 Take notes, ask questions, make comments, participate actively.
- 2 If you can't follow the speaker, ask questions immediately.
- 3 Attempt to learn something about the subject matter before the

meeting.

- 4 Have a list of prepared questions. If they are relevant, but not answered, then ask them.
- 5 Don't be intimidated or shy – if you have a query, chances are others will as well.
- 6 Find out where you can obtain a transcript of the talk.
- 7 Obtain an address so you can write to the presenter if you are still confused or unclear about some issues.
- 8 Attempt to integrate the material with what you already know.
- 9 Test the material before applying it – seminar presenters are not always correct.
- 10 Go to a library to supplement your learning, or consult Professor Google.
- 11 Be afraid, be very afraid! The sure-fire, get rich quick, ultimate trading system seminars are expensive, hard to implement and even harder to disprove. My crystal ball tells me you will be disappointed!

It is almost impossible to flip through the financial pages of any magazine or newspaper without coming across an advertisement promising instant wealth. This publicity invariably features a computerised system, newsletter or hotline that claims to have achieved spectacular results over the last few months or years. These services offered are usually linked to options or currencies because these highly leveraged positions are most likely to offer instant gratification. The huge leverage available significantly reduces time horizons to investors, consequently the number of trades (revenue for the brokers) is that much greater.

A great rule of thumb is the more money the system claims to make for you, the less likely it will. Consider this: if the system is so profitable why are the proponents sharing it with you? Bear in mind Mark Twain's claim 'there are lies, damned lies, and statistics'. Most of the system's claims of success are based on band-tested data in which buy/sell signals are generated by specific price actions. In addition, the specific time selected fits the data retroactively. If you invent the right rules it is easy to justify profits in the periods quoted – but there is no guarantee that these rules will encourage future successes. Heard that before somewhere?

Some questions to ask:

- 1 What was the length of the historical test? You need to see how the system fared in all types of markets.
- 2 Have the results quoted included commission payments?
- 3 Did the returns quoted have tax deducted?

- 4 What was the maximum number of losing trades?
- 5 Do the results represent worst- or best-case scenarios?

So who will give you advice on the investing process?

- ☐ Fund managers.
- ☐ Share brokers.
- ☐ Banks.
- ☐ Insurance agents/brokers.
- ☐ Financial planners.
- ☐ Accountants.
- ☐ Trustee companies.
- ☐ Real estate agents.

You can also collect information from the media: journals, magazines, newspapers, prospective research houses or even from courses at polytechnics or universities.

YOUR RELATIONSHIP WITH ADVISORS

With the best of intentions, you will probably talk to an advisor at some stage. So how can you find an investment advisor that you can have confidence in? First, remember that working with an advisor creates a relationship. You are 50 per cent of that relationship, and must, therefore, bear at least that share of success or failure on the path you choose to follow.

Interviews are conversations. The more you present regarding your goals and current financial situation, the better the advisor can work with you.

However, the final responsibility is yours.

The best way to get clear and useful answers is to ask the right questions. As your helpful author, therefore, I have a list for you. It is okay to make notes of the answers; it is easy to get distracted by the paintings in the office, shoes, nostril hairs or any other myriad impressions your brain is busy collecting.

- ☐ What are your ideas on how I should be investing? What have I invested in?
- ☐ Who are your typical clients? What kind of investments do they generally make?
- ☐ Will you help me plan for goals or simply provide advice?
- ☐ How often can I expect to hear from you?
- ☐ Do you adopt a broad view of your client's wealth, prospects and objectives?
- ☐ Do you encourage clients to make long-term commitments to investment policies?

- ☐ Do you encourage clients not to monitor results too frequently?
- ☐ Do you attempt to structure the client's portfolio to the shape that the client likes best (such as ensuring a decent return with a small chance of a large gain)?
- ☐ Do you identify the aversion of clients to the different aspects of risk and incorporate that into their investment programme?

After your discussion, prepare a summary of the interview. This can make it easier for you to choose whether you should work with that particular advisor. Many advisors will provide you with a written disclosure, which will answer some of your questions.

Did the person you interviewed treat you with courtesy and respect? Did they listen carefully to your questions and answer them candidly? Did the prospective advisor find out about you as an investor by asking about your income and assets, ownership or company structures, what your financial goals are?

Other aspects regarding your potential advisor that you need to examine are:

- ☐ **Experience:** Newbies do deserve a chance to prove themselves but not at your expense – at least five years' experience is not too much to ask!
- ☐ **Reputation:** You could ask for client referees and check out websites.
- ☐ **Affiliations:** Does the advisor work independently or as part of a national or international organisation?
- ☐ **Compatibility:** You are likely to have a long, and hopefully successful, relationship with your advisor – are you comfortable with them?

Other things you can do:

- ☐ Go to seminars, classes, professional meetings.
- ☐ Subscribe to magazines/journals.
- ☐ Use the web – an amazing amount of information in relation to discussion papers and tax law is easily accessible.
- ☐ Google your chosen topic.

Okay, you've chosen your advisor, you are doing your homework, what now? You have been clear and specific about your goals and assets and you have gotten off to a good start – the energy you've put into finding the right advisor is going to pay off.

But from the outset you need to nurture the relationship (sorry, guys). That doesn't mean harassing your advisor by phoning them weekly with pointless queries, but ensuring that communication

between the two of you is clear. After your first meeting ask your advisor to write you a report. You will have to pay for this, but it will be well worth it. This is so you understand your advisor's grasp of your affairs and the recommendations for the future. It will also help you reassess your goals and requirements once you see them in black and white. You may find you wish to revisit your instructions.

So far we have focused on what you want from your advisor. This is what your advisor wants from you:

- ☐ A client who is informed and involved and who has a clear sense of goals.
- ☐ A client who wants their advisor to generate ideas, provide concrete advice, but who wants to be an equal partner in making the financial decisions. Nothing is scarier to an advisor than the client who says 'Do what you think best!'
- ☐ A client who wants to be involved enough to initiate contact occasionally.

What to do:

- ☐ Read everything you have been given.
- ☐ Stick to your plan and take your plan seriously.
- ☐ Be interested, ask questions.
- ☐ Take a long-term view.

What not to do:

- ☐ Don't be passive.
- ☐ Don't second guess or agonise over possible scenarios.
- ☐ Don't expect to get rich quick.
- ☐ Don't expect a babysitter.

Generally Accepted Investment Principles

- 1 Investors should establish an emergency fund invested in short-term safe assets and not held in retirement accounts.
- 2 The percentage of assets invested in stocks should decline as an investor ages. A popular rule of thumb is to subtract a person's age from 100 and invest that percentage of total assets in stocks.
- 3 The percentage of assets invested in stocks should increase with wealth because wealthy individuals can generally tolerate greater risk.
- 4 All investors should diversify their portfolios across asset classes, and the equity portion should be well-diversified across industries and companies.
- 5 The optimal asset mix might differ from standard recommendations because of risk preferences.

6 Time horizon, risk tolerance, income stability and other factors influence asset allocation.

The term 'Generally Accepted Investment Principles' derives from the term 'Generally Accepted Accounting Principles' or GAAP, which refers to accounting standards or rules used in preparing financial statements.

Financial Principles

When making any investment decisions in today's uncertain climate, the following financial principles should be followed:

- ☐ You should have appropriate risk investments.
- ☐ You want the highest returns possible balanced with your level of safety.
- ☐ You want maximum flexibility.
- ☐ You want to minimise your tax.

In order to obtain high rates of return and relative safety, you need to spread your risk. You can spread your risk as follows:

- ☐ Geographically with money invested in New Zealand and money invested offshore.
- ☐ By using different fund managers.
- ☐ By investing in different investment areas, such as fixed securities, property, shares and bonds.

We have dealt with the psychological aspects of investing (at some length) so now it is appropriate to examine the investment process. It should be clear to you by now that the best way to overcome biases is to have a written plan – it will act like the seatbelt your pilot orders you to wear when flights become turbulent.

Investing is a process composed of many elements. Many so-called investment books or websites should probably be renamed 'share' or 'manager picking' in that they only briefly address, or skip entirely, critical elements of the process. In fact, fund selection is probably one of the least important elements. A summary of the planning steps follows.

THE ASSESSMENT PROCESS

What are you worth? How much are you saving? Before you can begin planning you need to know exactly where you stand financially. The best New Zealand site for financial calculators is <www.sorted.org.nz>. If you don't want to use it or are not able to access the internet, banks, insurance agents and financial planners have net-worth calculators. It is important to realise that net worth

and cash available to invest are two separate amounts. An income statement will give you an idea of how much money is coming in or going out on a regular basis. By preparing financial statements you'll be able to more effectively determine your needs now and in the future. Don't have an anxiety attack; it may not be as bad as you think.

What are your goals? How do you want to achieve those goals and when? The first step is to quantify the amount required for your goal and the date you want to achieve it. Before an appropriate investment programme can be established, careful consideration should be given to the investor's specific objectives and constraints.

Objectives are goals defined in terms of return environment and risk tolerance. Constraints are limitations such as liquidity, time horizon, taxes and legal or regulatory matters imposed on the portfolio management process. Preferences are constraints that are self-imposed and may be unique. Do you have specific income requirements or minimum rates of return? Is there a minimum value that must be maintained? Are there specific future liabilities? Investors with more wealth than they need may be interested in donating some of their wealth to charity. Keep in mind that the real value of any dollar amount in the future will be influenced by inflation.

Knowing how much you have to invest now and in the future can help you estimate the future value of your lump sum investment, your lump sum plus a stream of investments, or simply a stream of investments (again go to <www.sorted.org.nz>). You can calculate your savings potential or the rate of return you need to achieve your goal. If your goals are unrealistic you may need to rethink them or reconsider your investment strategy.

Are you willing to accept volatility to achieve higher returns? Investing should be viewed as a process of making sure that you never have so much risk that your standard of living can be impaired by a negative surprise. You have by now already completed your risk tolerance quiz and should have a pretty clear picture of your investment personality.

A Practical Exercise

- ☐ List all the feelings you have about money, and can ever remember having (envy, greed, sadness, happiness, relief, fear, anxiety ... and so on).
- ☐ Next, record your most memorable life stories relating to these feelings – look especially for patterns and repetitions.
- ☐ Identify the feelings these money stories arouse.
- ☐ Finally, write out the money stories you will have after you have

put your plan in place.

At this stage in the process you should ask yourself several questions. First, do you know enough about investing (asset allocation, portfolio management diversification, etc.) to handle your own investments? Have you done well with your investments in the past? If the answer is no, you either need to seek an advisor or to become educated. Are you willing to accept lower returns and higher risk than you might obtain through using a qualified advisor?

Knowledge Quiz

This is not a yes/no quiz; this requires you to write answers to each question, thus establishing any areas of weakness you may have. Remember, like a house, a good financial plan is dependent on a strong foundation.

- ☐ When you are presented with an opportunity to learn more about investing, are you interested? Or do you ignore it?

- ☐ Do you have a clear vision of your goals? If you don't, how can you plan?

- ☐ Do you have a clear timeframe in which to accomplish your goals? Do you have your goals quantified?

- ☐ What is your present financial status? Do you know your net worth?

- ☐ What is your monthly income? What are your assets? What are

your liabilities?

☐ Are you likely to inherit money? If so, how much?

☐ Have you made a budget? Do you adhere to it?

☐ Are you saving enough to meet your goals? If not, what steps will you take and over what timeframe, to boost your savings up to an adequate level?

☐ Have you sought professional help? If not, why do you hesitate? What stands between you and access to the kind of expertise that could help you clarify and accomplish your goals sooner than you may be able to do on your own? Why don't you use a professional as a mentor?

IF YOU DO IT YOURSELF (DIY)

You will need:

- | | |
|-------------------------------|---------------------|
| • Discipline and organisation | • Persistence |
| • Positive attitude | • Independence |
| • Self-confidence | • Contrary thinking |
| • Well-rounded personal life | • Isolation |

- Consistency
- Control of emotions
- Honesty with yourself

Even if you use an advisor you should understand the basics of portfolio management and diversification and be familiar with historical rates of returns and risks for the major asset classes. Investing is not rocket science. Your next question should be: do you have the time to handle your own investments and is it the best use of your time? If you are foregoing income opportunities, or even that elusive free time, an advisor may be best for you.

If you are lacking in self-control then no amount of advice will help. Before you employ an advisor you must decide whether you can follow through on their recommendations thoroughly, honestly and for an extended period of time.

Determining the appropriate asset allocation is the most important part of the investment process because it will likely determine the majority of both risk and return for your portfolio. The more risk-averse you are the more you should diversify. The assets' best allocation will depend on the expected returns, volatility and correlation between assets. The objective is to achieve the highest return given the risk level acceptable to you, or alternatively to assume the minimum risk required to achieve a specific amount.

Whole books have been written on asset allocation. I don't propose to give you more than a couple of pages. Asset allocation is the primary determinant of both risk and return in many portfolios. Numerous studies have concluded that the percentage distribution of financial assets (cash, shares, government stock, real estate and other investments) accounts for much of the variability of a portfolio's return, while market timing and security selection account for a much smaller percentage. The broader asset classes can be subdivided further into small cap and large cap, growth or dividend producing, international and national combinations of both. Government stock and debentures can be subdivided into short-, medium- and long-term, convertible and international. Adding high-risk asset classes and investments to a portfolio may seem risky but its likely net effect will be to both increase returns and lower the risk of the portfolio. For example, adding international shares to a New Zealand portfolio lowers the risk because the assets have low correlation. That is, our market performs independently to that of the offshore markets, so rises and falls rarely occur in tandem. There have been many studies on the results of asset allocation and it has been found that over 80 per cent of returns are attributable to asset allocation – that is, the

allocation among shares, fixed interest and cash is much more important than the individual securities you select.

Many studies have shown that the percentage of distribution of financial assets (cash, shares, government stock, property, derivatives) accounts for much of the variability of a portfolio's return. That is, selecting the 'correct' asset class is the primary determinant of your return. Asset allocation should be consistent with your goals, your acceptable level of risk and time horizon. The goal is to obtain the highest return with the acceptable risk level, or alternatively the lowest risk for the required return rate. Remember too that by combining assets that are not correlated with others, an investor can achieve higher returns with lower risk over the long term. And, as I keep on saying, adding high-risk asset classes to a portfolio may *seem* risky, but the net effect will be to increase returns and lower the risk.

Stocks represent ownership in the most creative aspect of the economy, namely a company's ability to devise and produce new products and solutions. By contrast, bonds stand for debt – money lent to productive capacity, while real estate houses that capacity. Neither bonds nor real estate contribute to the economy the way shares in a company do. Since they stand at a further remove from the source of production, they return less.

Once you have determined your asset allocation you need to choose benchmarks that you'll use later to evaluate your results and determine how well your investments have done. (If you have an offshore portfolio you use the world sharemarket index as a yardstick.)

At this point you will need to select your investment vehicles and implement your strategy. If you have chosen to use an advisor, she will handle the implementation for you. You (and your advisor) need to evaluate tax free, tax prepaid or tax advantaged vehicles, an area that is becoming increasingly complex. Taxation has a bigger input on your returns than inflation or costs – you need to eliminate or reduce the tax bite.

The second decision, and one many investors don't consider, is the decision to invest actively or passively. Passive investing (or indexing) involves purchasing diversified portfolios of all the securities in an asset class. Active investing involves overweighting securities and sectors within an asset class believed to be undervalued, and underweighting securities and sectors believed to be overvalued. Purchasing shares directly is an active investment. Bear in mind you can make the correct asset allocation and be wrong in your active security selection and vice versa.

Arguments can be made for both active and passive investing. Passive investing brings with it reduced costs, tax efficiency and the

fact that, historically, passive funds outperform the majority of active funds. The argument for active investing is that anomalies can be exploited to outperform passive investing. The active versus passive decision does not have to be one or the other, in fact a strategy I recommend for clients is to invest passively in efficient asset classes and to invest actively in markets and asset classes that are less efficient. Investors can also combine the two by investing part of a portfolio actively and another part passively (for example, you can invest half of your stock allocation in an index fund and the other half in an active fund).

I have already mentioned using managed funds, but you should also consider investing directly in shares (domestic and international), government stocks or real estate. A major advantage is that they provide diversification within asset classes.

In every group of investors there is at least one who is convinced that market timing is successful, for them. This means their buying and selling is based on buying on the low and selling on the high. Most studies show that attempts to time the market are unsuccessful, to put it mildly. It will not only decrease the value of your portfolio, but will also be counterproductive.

Your next step is to monitor your portfolio, re-evaluate goals and constraints, and rebalance. When ranking performance, specific time periods should be shown and, of course, will be determined by each investor. At that time you compare your returns against the benchmarks you have selected to determine whether your active decisions have resulted in better than market returns. If they haven't it may be time to re-evaluate your strategy. It's also a good idea to determine whether your portfolio has fluctuated more or less than you had expected, and to adjust your expectations and portfolio accordingly. In addition to this, re-evaluate your goals and constraints. This may lead to you rebalancing your portfolios.

During the investment period you may have had dividends, income payments, inflows and outflows of cash, or other events may have occurred that will require you to rebalance your portfolio. For instance, a rising sharemarket can cause your portfolio allocation to rise above predetermined ranges. Therefore, it is helpful to have a regular reassessment time.

Finally, you need to document your results. You should always maintain appropriate documentation and records of your investment – if you have an advisor she will do that for you. You will need the records not only for tax purposes, but to compare one year to another. I suggest that you also document your views and emotional responses; it will help you identify and control your biases.

IMPLEMENTATION – THE KEY TO EVERYTHING

Without implementation there is nothing. Understanding without action is nothing more than an academic exercise. Once you have established your biases you must act immediately or the opportunity will be lost.

‘Opportunity doesn’t knock once. It’s pounding on the door, tearing off the roof, and kicking in the windows all the time. It’s a matter of perspective, of being willing and ready to see it.’

- 1 Plan specifically and well in advance – keep your plan available. If you are specific and organised and act on plans, you will avoid losses caused by spontaneous decisions based on others’ opinions.
- 2 You alone are responsible for the success or failure of your plan. You must assume responsibility and not blame advisors, friends or the media for errors. This will help you avoid emotional decisions and, more importantly, you will learn that you are in control. Consistency, not genius, is the single most valuable key to success.
- 3 Never hope your investments will give you a massive profit or fear a massive loss. Both these attitudes lead to unrealistic expectations, emotional decisions and negative attitudes. Hope and fear are two of the greatest enemies of successful wealth creation.
- 4 Monitor your portfolio’s performance – feedback of results is important. You need to know that your plan is working for you. You will only be able to ascertain this if you keep a record and, thus, know how well or how badly you are doing. You need to know if poor results are caused by your selection of assets or market performance.
- 5 Attitude is your greatest asset in investment as in ‘real’ life. The only way to combat the negative effects of losses, interference by others and errors of judgement is by the maintenance of a positive attitude.
- 6 Cultivate positive and effective relationships. We are influenced by those around us. If we surround ourselves with negative people we will not be positive. If we associate with those who are highly motivated, who seek to achieve, who have ambitious goals and who are willing to forge ahead regardless of obstacles, then we will acquire similar drives.
- 7 Don’t take your portfolio to bed with you. By this I mean don’t allow your financial life to have too much influence in other areas of your life. This can be destructive. Your investments are a means to an end – they are not a way of life and should not dictate your every move. By being too close to a situation you sometimes cannot see it for what it really is.
- 8 Enjoy your money – spend some profits, save some profits. You must experience the positive feeling of using profits to acquire some of

the things you want.

- 9 Avoid overconfidence – it could be your greatest enemy. There are good times in the market, and there are bad times. But just as you should not allow the bad times to bring you down, you must not allow the good times to give you a high. Either of these emotional extremes can impair your judgement and you will be either too brave or too timid. Each loss is a negative experience, but not a totally destructive defeat. Similarly, each profit should be taken in your stride.
- 10 Your next goal should always be in your sights. Once you have achieved one financial goal, move onto the next – your financial plan should have these goals incorporated at the outset.
- 11 Be mentally prepared for mortgage rates to move against you, your portfolio to drop 25 per cent or for many other financial disasters that can afflict us.
- 12 DO NOT PANIC.

Rules of Thumb for Planning

The key concept here is ‘on-purpose living’. All of us, if we want to make positive changes in our lives, need to identify what might be called the point of our existence, the thing that is most important to us. Once we have that, everything else can be organised around it.

You find your purpose by asking yourself some deep questions. What is the one thing that you want to be present in all of your activities? What is the most important thing for you to experience on a regular basis? When you discover what that is, everything else – decisions, motivations, goals – become clearer and more achievable. Your purpose becomes your mainspring, and you begin to order your life in a different way.

If you try to make changes without having them linked to an overarching purpose, then those changes are either hard or impossible to sustain. If you don’t know what’s important to you in your life, if you don’t know the why behind your efforts, then you could give up on your endeavours in life and in business.

A Financial Planning Example

Consider your savings habits – you know you should spend less than you make. You may vow to pay off credit card debt or reduce your mortgage. But if you can’t link that to a purpose, something that is truly important to you, then you’ll revert back to the behaviour that got you into trouble in the first place.

So Where Do You Start?

Start by doing a simple self-assessment. Are you living life on-purpose

or off-purpose? Are you living life intentionally or accidentally? Are you simply hoping for a different reality? Or are you recreating your life through action, based on a well thoughtout strategy and plan?

As you go through the planning process, it is also important to give up on the idea that your future life is somehow burdened by the past. No, you can't change the past, but you can make a decision today to create a brand-new ending to your personal story.

You and Your Maserati

'The human brain is ... a
Maserati.'

- Read Montague

The human brain is a superb machine, 'a Maserati', says neuroscientist Read Montague, when it comes to solving ancient problems like recognising short-term trends or generating emotional responses with lightning speed. But our brain is not so good at discerning long-term patterns or focusing on many factors at once – challenges that our early ancestors rarely faced but we as investors confront every day.

BEHAVIOURAL FINANCE

Advances in behavioural finance and neuroscience have helped clarify why we make the financial decisions we do. The research reveals areas of emotion and impulse that drive us all – research that is based on behavioural psychology, evolutionary biology and neuroscience. Behavioural finance explains why even sophisticated investors stray from their investment strategies, and why we make the financial judgements and purchasing decisions we do. Behavioural finance takes a prescriptive approach to our behaviour, a stimulus (the urge to buy or reward approach) followed by a (frequently irrational or loss avoidance) response; from this we can fashion a prescriptive approach to our financial strategies. New imaging techniques used in brain research – neuroscience – thought and emotional processes to be tracked in the black box that is our brain.

NEUROSCIENCE

Researchers typically describe the brain as having three parts. The cortex, or neocortex, is the outer part of the brain which differentiates between making good and bad decisions. This part of our brain is the 'newest', that is, the latest part to develop, and it is responsible for things like learning logic and language.

The middle part of the brain is the limbic system, which controls mood, memory and hormones. The central and oldest part of the brain

fits inside the limbic system and is called the R complex (R standing for reptilian). It controls our basic responses like the fight or flight response and defending territory. All three parts of the brain interact throughout our lives, though not about everything all the time; for example, the reptilian brain doesn't check with the cortex to get clearance on breathing. Consider your response if you come across an accident. The reptilian brain responds with 'danger!', the limbic system registers your emotional response – fear, sadness or concern – and the cortex says 'slow down' or 'I should stop and help, where is my cell phone?'

The point of this discussion is to bring you the finding of neuroscientists, which is that the strongest level of communication comes from the ancient reptilian brain and often can override the higher functions of the cortex.

Neuroscience has identified two major motivators hardwired into our brain. These two systems motivate either desire to pursue potential rewards or desire to avoid potential losses – the reward approach and loss avoidance systems.

If we identify a potential gain, the brain's basic and ancient reward system is set into motion: the same reward system that scientists have identified in life-forms as primitive as amoeba. In short, our financial decision-making is biased in ways more suited to our ancestors tracking footprints in an attempt to catch dinner, or searching for edible roots, than today's financial environment.

Functional Magnetic Resonance Imaging (fMRI) looks inside the brain and records the areas that 'light up' in response to thought patterns. The brain has two key subsystems: the *limbic* and the *paralimbic*, the heart between our ears; and the *analytic*, our organic computer, centred in the front and parietal cortex. The limbic and paralimbic system rule our emotional responses to events, or how we respond to others, or to their treatment of us. The analytic system is the structured part of our brain involved in calculated, conscious, future-oriented thinking. The analytic system has no base in past experience; it is the part of the brain that understands the rules of a brand-new game and can figure out how to play.

Researchers have shown that the interaction between the analytic and limbic systems govern our behaviour. The limbic system seems to discount the future, while the analytic system remains constant from the present onwards. In practice, this means that the limbic system controls the moment but loses focus as any possible rewards move into the future. The limbic system is in control of instant gratification. For instance, would you rather have \$20 now or \$25 in two weeks' time? Most of us pick the \$20 now, our limbic emotional response overcomes our analytical response that knows that \$25 in two weeks'

time is more valuable. Or that slice of pizza overcomes the good diet plan. Thus, temptation wins out over preference. Both parts of the brain can work at cross-purposes while making a decision. The trick for us is to convert our financial decision-making into a language that appeals to the different parts of the brain and motivates a decision in our favour. Sound familiar?

We are not able to visualise the origins of buying and selling behaviour, consumer decision-making and brand preference but, experimentally, marketers have modified information to influence our buying and selling decisions. Through systematic experimentation, they have established how immediate gain dominates over future potential reward characteristics. Stimuli that activate the reward system include chocolate, money, pictures of attractive people, food, drink, sports cars and luxury brands (for women).

The reward system runs from the midbrain (the reptilian brain) through the limbic system (the emotional brain) and ends in the neocortex (the brain's centre of executive function). The neurons that carry this information predominantly carry the neurotransmitter dopamine, the pleasure chemical of the brain.

The prefrontal cortex is activated by receiving money and the nucleus accumbens, one of the brain's key pleasure centres, by anticipating a chance to get money.

BIOCHEMISTRY

In our investment and purchasing decisions our goal, however, is not to do what comes naturally, but to make a profit or a good buy. Recent research bears this out; 95 per cent of all consumer decision-making occurs subconsciously. The eminent researchers also found that money makes us nutty. There's a surprise! They concluded that we *should* treat money merely as an exchange mechanism that allows us to get stuff, but that distinction is lost on our brains. The dopamine release that makes a juicy hamburger so satisfying works the same magic even if we find enough money to buy the hamburger.

Now that I've mentioned dopamine let's look at our brain and what it does to financial decision-making. Take a tour of your brain and identify those blind spots that sabotage profit potential. Do you recognise these behaviours?

1 If you buy lotto tickets or bet on horses, it's your **dopamine** that is driving you. The less likely a reward, the more active your dopamine neurons become and the longer they fire, flooding your brain with a soft euphoria, but, if the expected reward fails to materialise the dopamine dries up instantly, which can make for a wrenching and rapid swing into depression. The larger the reward anticipated, the more dopamine is released. Surprisingly, receiving

a reward is not as satisfying as the anticipatory phase. Elevated levels of dopamine are associated with extremely focused attention, unwavering motivation, goal chasing and learning about new things. It can lead to hyperactivity, sleeplessness and loss of appetite. In a normal, healthy body **serotonin** produces contentment but during periods of elation can produce an opiate-like high. **Serotonin** is depressed by disappointed expectations (such as an investment loss) and can be associated with serious emotional and behavioural consequences, such as feelings of anxiety, depression, increased impulsivity and irrationality, thus paralysing investors from taking risks or over-trading in the frantic search for profits. Unfortunately, the negativity surrounding losses are emotionally weighted twice as heavily as positive gains. Healthy people who are passionately in love have unusually low levels of serotonin, a characteristic they share with obsessive compulsives.

- 2 If you fear losing money, your **amygdala** is responsible. It's the brain's early warning system that triggers the fight or flight response. Many investors opt for flight selling at the bottom of the market.
- 3 You remember the crash of 1987, and stories of the great depression? Your **hippocampus** is activated by financial losing streaks and helps form memories of fear and anxieties. This is why you are unwilling to buy when shares are cheap, during market crashes and afterwards, yet you buy during sales in all other areas of your financial life whenever you can and boast about it.
- 4 You buy when the markets are rising as the only way is up. This is your **prefrontal cortex** controlling you; it stores sets of events in the form of memories, to draw expected outcomes from patterns. One of the other actions your prefrontal cortex is in charge of is making balanced judgements. Unfortunately this ability reduces with age, so if you are over 21 you may need a financial minder.
- 5 The rising market you have bought into falls like a stone and you feel sick. This is your **insula**, **caudate** and **putamen** generating feelings of fear and anxiety. The longer a pattern has previously repeated the more violently your brain responds when the pattern is broken.

Is Your Brain Wired for Wealth?

1

Your broker
calls offering
you shares in

an IPO that everyone (including him) thinks could be 'the next Microsoft'. What do you do?



Buy it
Investigate what percentage of IPOs have ever made money for their investors. Ask why he never told you about the first Microsoft. Tell him you've gotta run because you're getting ready for an unpleasant medical exam.



2

A company you own has beaten analysts' earnings forecasts by exactly one dollar for eight straight fiscal quarters. What do you

think will
happen if,
next quarter,
the company
earns
one dollar
less than
analysts
expect?



The stock will
go up by a
tiny bit.
The stock will
go down by a
tiny bit.
The stock will
lie there like
a patient
anesthetised
on a table.
The stock will
drop like a
battered
brick.

Whenever
anyone asks,
you always
say you have
a 'high
tolerance for
risk'. After
all, you like
longshots at
the track and
you never
hesitate to
buy shares
that you
think will go
up, even if
the experts
call it risky. If
your portfolio

drops 30 per cent over the next year, what are you most likely to do?

☐

Buy more of whatever's gone down the most.
Take money out of whatever's gone down the most and move it into whatever's gone down the least.
Buy more of everything you own.
Yawn.

☐☐☐

4

When you make money on an investment you tell yourself:

☐

'Right again – am I a genius, or what?!'
'Whew! That was close!'
'What can I learn from this?'
'Man, am I lucky.'

☐☐☐

And the answer is ...

1 \$20 – the share price has doubled three years in a row, why would it

- not continue? (The prefrontal cortex takes over and the only way is up!)
- 2 Buy it of course! (The dopamine effect – it's a pleasure, I'm spending the profits already.)
 - 3 The share price will 'drop like a buttered brick'. (Amygdala, your early warning system, suggests flight is the answer.)
 - 4 Sell, sell, sell! (Hippocampus activation, losing streak coming up.)

Our knowledge of the brain's hardwiring is in its infancy and is still fairly general but behavioural finance is now a couple of decades old. We can easily identify the psychological biases that inhibit our ability to create wealth. Once these are identified we can implement a strategy to sneak up and subvert our automatic and unconsidered response to events on the financial stage. All investors feel the pull of habit, their behavioural patterns, but can lack the knowledge that helps them understand where their feelings are leaving them.

Tomorrow's Success

'Nothing endures but change.'

Heraclitus

CHALLENGES

Are people rational? Yes, no and sometimes. Plato compared the human soul to a chariot pulled by two horses, that of reason and emotion.

Are people rational? This has long been a question for philosophers and psychologists, especially those focusing on thinking, reasoning, decision-making and social judgement; but increasingly economists have become interested in these questions. For many years economists have suffered embarrassment when the financial behaviour of people failed to conform to their finely crafted economic theories. This is because economists viewed people as rational decision-makers who carefully evaluated investment evidence and acted to maximise outcomes. But many years of research have shown that most of us often don't act rationally at all.

During the 1990s more and more people entered the world of investment. Money news is now as much part of our daily experiences as news of murders, plane crashes, famine, flood and terrorism. We filter an amazing barrage of investment periodicals, television shows and newspaper articles by 'the expert', 'the professional' and 'the leading authority'.

We have more financial options and more financial responsibility than we have had at any other time in history. There are also seminars that promise extraordinary profits, sometimes promoting speculative and risky schemes. Despite the rise of information, several recent studies indicate that *investor* success does not mirror *investment* success. Terrence O'Dean did a study of 10,000 discount brokerage accounts from 1987 to 1993 showing that, on average, the shares investors sold beat the market by 2.89 per cent after two years and those they bought underperformed it by 0.68 per cent. Here's how they lost out overall after two years:

Lost value from shares sold:	-2.89 per cent
Underperformance of shares bought:	-0.68 per cent
Transaction costs:	-5.90 per cent
Total value lost:	-9.47 per cent
Source:	
< www.businessweek.com >.	

Investors need to understand the impact their psychology has: on them and on those around them.

For most of us the task of beating the market is not difficult, but beating our own mindset is a different story. In this sense, beating ourselves means controlling our emotions and attempting to think independently. Decisions based on our natural instincts invariably turn out to be the wrong course of action. We would all be comfortable selling when the prices are low, and buying when they are high – when we know our investments are valuable. We need, however, to adjust our attitude and do the opposite.

Success based on an emotional response to market conditions is the result of chance, and chance does not engender consistent results. Objectivity is not easy to achieve because we are subject to fear, greed, pride and many other biases. We can read books, attend seminars, study the words of geniuses, but all the knowledge in the world will be useless without the ability to put it into action – we spend too little time trying to overcome our frailties.

Considering an investment and actually making one is different. That commitment of money usually means objectivity falls by the wayside and emotion takes over.

Some of the brightest minds in the world are devoted to making profits, yet newcomers to the financial scene naïvely believe that with minimal knowledge and experience they too can make a quick killing. Many of us are unrealistic and have been brainwashed into thinking that investing is easy and does not require much thought or attention. We hear through the media that others have made quick and easy gains and conclude incorrectly that we can participate in these with little preparation and forethought. Nothing could be further from the truth. There is no rapid road to easy riches.

People make investment decisions involving thousands of dollars on a whim or from a comment from a friend or associate. Yet, when buying an item for the home where less money is at stake the same people may reach a decision only after great deliberation and consideration. If you react to news the same way as everyone else you are destined to fall into the same traps, but if you can rise above the crowd, suppressing your own emotional instincts by following a

carefully laid out plan, you are more likely to succeed. Your results, however, will depend on the degree of commitment you bring to the implementation of that plan.

All markets reflect the attitudes and expectations of its participants in response to the financial and economic environment. People tend to be universally greedy when they think prices will rise, whether they are buying gold, currency, shares or property. Conversely, their mood can easily swing to fear or panic if they are sufficiently persuaded that prices will decline. Human nature is the same in all markets the world over.

Many investors believe that technology will alter the nature of the markets, believing that factors such as the internet and our greater financial savvy will mean more profits and less risk. But they are wrong. Although the markets of tomorrow will, in some ways, be very different to current markets, they will, in many basic respects, be the same. Markets are ruled by emotion; if they were not, they would not exist. If markets functioned as perfect economic systems, prices would always be at the right level and there would be no need to anticipate market direction. There will always be uncertainty and uncertainty will prompt emotion. Emotion will stimulate volatility and significant price swings. Ultimately it will be the rational, informed, self-disciplined investor who reaps the rewards.

Let's examine the aspects that will affect our investments in the future.

- 1 New financial investments are constantly coming onto the market and investment structures previously available only to the wealthy are now available to average investors. Hedge funds are a case in point. In addition to this, new legal structures will appear and taxation laws will continue to alter.
- 2 Real-time trading is now available, buying and selling online will continue to become more widespread, so for those who invest directly this will create more uncertainty and will exacerbate uncontrolled biases. Online trading, financial advice and research tools and information have transformed the way traditional services were delivered and offer a vast assortment of new services.
- 3 An interesting development will be in the creation of neural networks – claims have been made that programs now possess the ability to reason and learn from their mistakes. Can artificial intelligence develop biases?
- 4 Global influences will become even more pronounced – what happens in Venezuela will affect what happens in Moscow. The butterfly effect.
- 5 The speed and ease of communication will continue to increase and not only will the news from distant countries reach the market

faster but news discrimination will impact more quickly.

- 6 Global corruption will increase as all nations advance technologically and economically. There will be more demand for industrial commodities, agricultural commodities, money, fuel and so on. This will make more opportunities for investors.

Tomorrow's Success

Tomorrow's success will require the same skills as today's success.

One of the goals of this book is to explain what psychology means for investors' financial decision-making. Behavioural finance and neuroeconomics are no longer controversial subjects. Economists are now accustomed to thinking about the role of human behaviour in driving markets and are routinely incorporating behaviour they observe in the real world into their models. After all, to do otherwise would be irrational.

Some neuroeconomists are claiming that their brain-scanning experiments are the start of a revolution in economics. No longer will economists rely on crude statistical models of how people behave in response to a policy change, such as an interest rate rise or a tax increase. Instead, they will be able to peer directly into the brain to predict behaviour. One day, perhaps; but much work remains. So, our answer to the question 'Are people rational?' is 'Yes' in the sense that we have highly adapted intelligence with the ability to learn from our mistakes and 'No' in the sense that we are rather poor at explicitly following the rules of logic. We could also answer 'Sometimes', in that people make good and bad decisions as a result of these limitations and abilities. Training and education can increase our abilities and minimise our limitations in a rapidly changing and uncertain world.

The Next 'Big Thing'

I am often asked to advise clients on whether they should invest in the next 'big thing'. A quick consultation with Professor Google reveals over 100,000 entries relating to a bewildering variety of sectors: music, cars, typefaces, drugs, engines, quantum computers, and so on.

The next 'big thing' will be predicated on two powerful sources which will grow stronger over time. The first we are very familiar with: telephones, video conferencing, and the internet. The pace of growth in these areas over the last decade has been astonishing.

Today we see electronic delivery of low-skill services, such as data entry, telemarketing or call centres, and the beginning of the delivery of high-skill services, such as radiology, engineering, architecture and education. Where to now? No doubt we will see continued improvement in technology and maybe even the invention of new forms of communication.

The second driver is the tide of workers, around 1.5 billion at one count, entering the world economy from places such as China and India.

The problem as I see it is identifying exactly which investment to pursue. Investment history is littered with investor casualties; for each 'big thing', like Microsoft, there are thousands of 'big things' which quietly – or sometimes noisily – implode. Consider Enron; according to the hype, it was the most exciting energy provider in the world. When Enron crashed and burned it took its employees' livelihoods and investors' superannuation funds, and left shareholders with nothing.

I suggest that if you are approached by someone wearing a pointy hat, and carrying a wand and crystal ball, you should follow their advice; until then, stick to basics. Seriously, though, by the time we hear about the next 'big thing' it is likely to be too late and therefore overpriced. One of the frustrating characteristics of new companies is that, although they may make money, they may not make enough money to pay back shareholders. What is worse, sometimes they call upon shareholders to shore up the business. Remember the proverb 'Throwing good money after bad'; as an investor, you need to control your biases and follow the practical steps I have outlined.

The Last Word

A final piece of advice: remember Murphy's Law. This is the belief that if something is going to go wrong then it will go wrong at the worst possible time. It refers to trials such as a traffic jam when you are running late; food spilt on your clothing before an important meeting; or the power going off when you are in the middle of cooking dinner.

In fact, a panel of experts – a psychologist, an economist and a mathematician – developed the Murphy's Law formula for British Gas. The formula is $[(CU + C + I) \times (10-S) / 20 \times A \times 1 / (1-\sin (F/10))]$.

The psychologist, Dr David Lewis, claims that to pre-empt Murphy's Law you need to change one of the elements in the equation. The five factors that need to be assessed are: urgency (U), complexity (C), importance (I), skill (S), and frequency (F); each is to be given a score between one and nine. The sixth factor, aggravation (A), was set at seven by the experts. Consider these factors in relation to your financial life – each of them has a part to play when you are making financial decisions. The researchers concluded by suggesting that, if you don't have the necessary level of skill to perform a task, leave it alone; if the task is urgent or complicated, find a simple solution; and if something upends your plans make certain you can cope with it. So, dear reader, create a financial plan, with an exit strategy, and be aware of your financial mindset.

HOW IT APPLIES TO YOU

As investors we must take a long-term view; that is, we don't talk long-term and act short-term. Decide calmly and rationally on a plan to follow, so although you may have a knee-jerk reaction to scary events you can refer back to your plan.

Investment decisions have both emotional and financial consequences, worry and pride, elation and regret or even guilt. The optimal decision is of little use to an investor who cannot live comfortably with the consequences. The right decision is irrelevant if it means you are likely to change course at the wrong time.

To maximise financial and emotional health we need to keep the objective factors (time horizon, liquidity needs, goals) uppermost in our minds as opposed to emotional factors (loss aversion, regret, and so on).

Regret would probably be the strongest force in making financial decisions – we not only regret what we have done, we regret what we haven't done. We focus our regrets on 'unusual' aspects, events leading to bad outcomes; in particular, actions we perceive as being 'out of character'. If you have followed someone's recommendations, and strayed from your normal path, the regret will turn into resentment and anger. Think of a bad financial decision that you have made which you now regret. Was it a decision to do something, or to refrain from doing something? What was the role of chance? One study came to the conclusion that people who regretted opportunities missed tended to take more risks than people who regretted attempts that failed. The risk-takers attributed little to luck but a lot to their knowledge and ability; they were under the illusion of control.

So what is the key to financial success? To make wise decisions you must have the right information, and combine and weigh its various components correctly. You must not ignore valid information in favour of thinking and judgemental tendencies that are dangerous in the investment world; for example, weighting the most vivid and recent information more strongly than heeding the lessons of history.

Investors must develop a mindset that helps them understand and adapt to the financial environment. Money is an emotional currency that relates to our individual need for security, power, respect, love, esteem and self-determination. If you don't know who you are, the investment world can be the most expensive place to learn. The psychic conflict between the temptation of profit and fear of loss makes investing a dangerous game for many people.

To change our financial behaviour we must learn new skills, moulding the knowledge of behavioural finance and neuroscience. Investors must focus on imperatives such as motivation, knowledge and understanding, wisdom and discipline – the focus is not on how to

pick shares, get rich in the property market or get rich quick – the focus is on the psychology of investor success.

Only the powerless live in a money culture and know nothing about money. Ignorance about money and power is not an effective means of acquiring, redefining or redistributing them. A political, 'sophisticated' or religious horror of money dangerously avoids the fact that, in a money culture, it is only money that buys the things that all people want – and deserve: life, health, food, land, hope, education, sexual pleasure, and some peace of mind.

Phyllis Chester and Emily Goodwin

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